VLTAVA FUND

Dear Shareholders,

The Fund's NAV grew by 7.2% in 2016.

Our largest equity positions at the start of 2017 were Berkshire Hathaway, Total Produce, BMW, WH Smith, and Teva Pharmaceutical. The regional distribution of the Fund's net exposure is approximately as follows: 41% Europe, 34% US, 13% Asia, and 7% Canada. Our portfolio is concentrated into investments we consider to provide the best combination of returns and risk. Sufficiently attractive investment opportunities are rather rare, and therefore we endeavour to utilise these to their best advantage. Our 10 largest positions make up approximately 69% of our portfolio.

In the current market, the Fund's portfolio is priced at less than 11 times the earnings of the past 12 months. This means that for the past year the net profits of our companies amounted to approximately 9% of their market capitalisation (that is their earnings yield, which is the inverse of P/E). In our opinion, that is an attractive yield considering the quality and prospects of these companies. This number stands out particularly in comparison to interest rates that linger close to zero. By our estimates, the fundamental value of our shares stands about one quarter higher than their current prices. A fundamental valuation is not something static, however. Rather, it develops through time. In the case of our portfolio, it is quite solidly growing. At the end of this year, it should be on the order of one-third higher than today's prices. This ought to create sufficiently strong pressure to push the prices of our stocks upwards.

Over the past eight years, which means from the Great Financial Crisis and at the same time from the change in our investment strategy, Vltava Fund's NAV has grown by 4.8 times. More precisely, it has risen by 387%. While it is true that the past eight years were very good for equity investments, our result is very good even by a global measure.

To achieve such returns, it is necessary also to have a little luck, and it is obvious that they are not sustainable over the long term. Be that as it may, we believe that we will remain among the better funds for a long time to come and that our returns will be good. Your expectations, though, should be realistic and should not be based upon returns from the past eight years.

In the next part of the Annual Report, as in the past, you will find quarterly letters to stockholders from the past year (taken together, these present a picture of our investments and opinions from last year) as well as more detailed data, including comprehensive historical results and audited financial statements.

We thank you for your support and goodwill through the years gone by and we look forward to our co-operation in the years to come.

Daniel Gladiš, February 2017

AN EXERCISE IN MARKET PSYCHOLOGY

Dear shareholders

In the first quarter of 2016, the Fund's NAV grew by 1.9%.

A roller coaster ride

Very interesting events played out through the first three months of 2016. Share prices headed sharply lower right from the first days of January. According to some statistics, it was the worst start to a year in several decades. Already by 20 January, that is after merely 12 trading days, US share prices had fallen by 9% and those in Europe by 12%. This provided fodder to various market commentators and forecasters, and in particular to those so-called "perma-bears" who have long had a negative outlook on the market in practically any situation. Awoken from their hibernation, they began popping up like jacks-in-the--box, and one could not open a financial newspaper or watch a financial news channel without being hit by a wave of dismal prognostications very nearly foretelling the end of the world.

There were plenty of arguments from which to construct such negative prophecies. For example: low and dangerously slowing growth in the global economy, deep recession in such countries as Russia and Brazil, complete uncertainty in China accompanied by a clueless and uncommunicative Chinese leadership, a veritable depression in the commodities sector as the number of mining company bankruptcies rose and problems worsened in countries dependent on commodities, rising yields (which means falling prices) on junk bonds, and, in contrast, extremely low interest rates as central banks continued to deform rates, and particularly those in relation to government bonds. Then, too, of course, there were the timeless old standards of unpredictable (if not entirely helpless) central banks and geopolitical risks.

To many, it was wholly obvious that prices would have to decline in such an environment. And decline they did, but just when it seemed the last ray of hope for a turnaround was fading prices unexpectedly and without warning began to rise just as rapidly as they had dropped. The turning point was around 10 February, by which time European share prices, for example, had slipped to nearly 20% below where they had been at the start of the year. By the close of March, however, the main US indices were just nudging above where they had begun the year and European indices had worked off most of their losses. Had this all been much ado about nothing? It almost appears so. Someone who had spent the first three months of the year meditating in a cave would conclude after glancing at current prices that nothing much had happened in that time and that it had essentially been a boring quarter.

Why?

Although for long-term investors like us who think in horizons of 5 years and longer these short-term price movements are truly not very important, we cannot avoid the question why? Why did prices first decline so much and then come back so strongly? We get asked this question very frequently, because it is just human nature to seek the causes of such events. In the case of share price fluctuation, the matter is not a simple one. **The actual causes of their movements cannot be determined with certainty, and prices frequently require no special reason to make large movements.** Nevertheless, we can at least speculate about their causes.

The most interesting fact about the large price movements this year was that they occurred within an environment which, while it may not be ideal for equities, is currently and essentially quite stable. The second paragraph of this letter could describe equally well the situation from last autumn, that from the turn of the year, and even the state of affairs today. Certain parameters have moderately worsened over that time, others have modestly improved, but it can essentially be said that all the risks had generally been known for a long time and recent months had brought no dramatic turning point which one could identify as an impetus to set off a large market swing. **Therefore, let us not seek explanations for this year's tumultuous share price movements in macroeconomic data but rather in market participants' shifting thinking.**

To date, this year has been a good example of how the market (and by this I mean the masses of people trading on the markets) sometimes interprets identical data in entirely different ways. Share prices were rising in autumn and then at the turn of the year – without any substantial changes in the data available to investors – those prices dropped sharply. After a time, prices moved just as abruptly upward again – and again without any substantial changes in what the data was saying. The main factor moving prices related to changes in investors' heads rather than changes in the data to which they had access. Investor psychology entirely ruled the market. Robert Shiller, my favourite contemporary economist, describes this with his "feedback theory". It is obvious that investors are not perfect machines without emotions but instead ordinary people with all their behavioural shortcomings and errors. They are subject to influences from their surroundings and the media, they feel safer when they act in accordance with the majority, and they consider price movements to be feedback confirming the correctness of their actions. All of this leads to exaggerated price movements (in both directions).

How should investors behave?

Unremitting price fluctuation is not the exception but the rule, and every investor must expect it. Properly coming to terms with this is important, but it is not simple. It is difficult to clearly formulate and remain focused on one's investment objective while at the same time controlling one's emotions. The following three rules may comprise the key to doing so successfully.

First, do not try to predict short-term price movements. To do so, it clearly would not be sufficient to predict the development of key data correctly (which is an essentially superhuman task in and of itself) but necessary accurately to predict the market's response to that data (which is more or less impossible). I have never heard of anyone able to predict short-term market movements systematically and reliably. Whoever understands this fact avoids the greatest errors.

Second, take a long view. Warren Buffett says that when someone thinks in the short term, with a horizon of 2–3 years, this cannot be called investing. Many people will be surprised that Buffet considers 3 years to be a short-term, speculative horizon, but we absolutely agree. Buffett recommends thinking in a horizon of 5 years and longer, and this is our practice as well. For such a long-term investor, short--term market movements are immaterial and most of the time can be ignored entirely. Speaking of Buffett and long-term investing, here is an interesting case in point: Last week, Buffett's company, Berkshire Hathaway, announced that its ownership stake in Wells Fargo, the largest Bank in the US, had reached 10% (USD 25 billion). Buffett had begun buying Wells Fargo's stock in 1989 – 27 years ago. At the time, he was 59 years old. I know of no one able to think with such a long view as he does. Maybe this is also why Buffett is the richest investor of all.

Third, ideally use price fluctuations to your advantage. This means that you should tend to buy when prices are declining and be more restrained when prices are climbing. Most investors do just the opposite. They sell when prices are going down because they wrongly believe that risk increases with decreasing prices and buy after prices have been rising for a long time and this has given them a false sense of security.

With the right positioning, large price fluctuations are a source of good investment opportunities. In our opinion, and although this cannot yet be categorically verified, the January drop in prices was caused in part by share sales from sovereign wealth funds (SWFs) of Persian Gulf countries. To put it mildly, low oil prices have severely stretched these countries' budgets, and they must patch up holes by selling assets. These funds are as mysterious as Jules Verne's Carpathian Castle – no one knows exactly what they own and do, but in any case they are truly large. Oil-exporting countries alone hold more than USD 4 trillion of assets in their SWFs. According to JP Morgan, this year these funds will sell shares in a volume of at least USD 75 billion (as well as more than USD 100 billion worth of bonds). All indications are that these SWFs were forced to sell at the start of the year, and this had a very negative but temporary effect in particular on share prices of banks and automotive companies. **So, what could be better for an investor than to have a counterparty selling under pressure and against its will?** We were therefore buying in the banking and automotive sectors, generally for exceptionally attractive prices.

VLTAVA FUND

The BMW shares in our portfolio saw their price fall during the first weeks of the year by almost one--third, for example, and so the market was pricing that company in mid-February at EUR 20 billion less than it had at the start of the year. Meanwhile, it cannot be said that the prospects for the BMW's future profitability had changed in any way.

The market sometimes offers attractive opportunities where a company's price and value differ so greatly that one must ask oneself in amazement, "Am I missing something here?" There have been such cases in the market recently. We are unequivocally benefitting from price volatility and it can be said that we welcome it!

As I stated above, the main indices at the end of March are approximately where they had been at the beginning of the year. Fortunately for us, however, they had slumped considerably in the meantime. If they had stayed flat through the entire three months, we would be cool, calm and collected, but we would have profited less over the long term.

Changes in the portfolio

We sold McDonald's and Walmart.

While most share prices declined substantially in January, McDonald's stock price continued to climb and even reached its highest level of all time. The price at 25 times last year's earnings seemed to us too high, particularly in comparison with other opportunities offered on the market, and so we took advantage of this opportunity to sell. Our profit on McDonald's shares was 35%.

Just a few years ago, Walmart was a company we liked very much and I even used its historic results in my book as an example of combined stability and high returns on capital. Things change all the time, however, and as we were progressively confronted with new facts all we could do was to adjust our opinion. In its domestic market, Walmart faces a growing risk from the "non-profit" organisation known as Amazon.com as well as the not yet large but very quickly growing German threat of Aldi. The lesson Aldi and Lidl taught Tesco on the UK market remains fresh in our minds, and we realize that even a seemingly unassailable market position cannot be taken for granted forever. Having also factored in Walmart's troubles on some foreign markets, we decided to sell these shares. Our gain on Walmart was 47%.

Although we did not open any new positions in the past quarter, we were quite actively adding to our existing ones.

Daniel Gladiš, April 2016

INVESTING IN AN ENVIRONMENT OF DECLINING COMPANY EARNINGS

Dear shareholders,

In the second quarter of 2016, the Fund's NAV decreased by 8.9%.

The earnings cycle

Our long-term investment philosophy is based on acquiring company shares at prices much lower than their values. A company's value today is the present value of all future cash flows the shareholders may receive from today until Judgement Day. The more money a company makes the higher is its value. That is scarcely an earth-shattering revelation, of course. How individual companies' earnings develop markedly differ from one another, however, and the collective profitability of all companies on the market also follows an irregular course. Nevertheless, a certain cyclical pattern can be observed. Let's take a brief look at the phase of the earnings cycle we are in currently.

Let's begin with the US market. According to data from Standard and Poor's, the total reported earnings per share in the trailing 12 months for all those titles

in the S&P 500 index combined peaked for the current cycle in the third quarter of 2014 at USD 105.96. The most recent earnings data, from the end of Q1 2016, put that number at USD 86.44. As is apparent, then, for more than a year and a half we have been living in an environment of declining company earnings and in that time profits have decreased by 18.4%. To put this into even better perspective, the two previous earnings cycles peaked in summer 2007 (at USD 84.92) and in September 2000 (at USD 53.7).

The earnings development for European companies is also cyclical, although the cyclicity has not been very apparent of late. According to data from Bloomberg, earnings per share of companies in the STOXX Europe 600 have been more or less unchanged for approximately 5 years, are lower than their high of 9 years ago, and are approximately at the level of 2005. European and US earnings had begun discernibly to diverge in 2010, after which time earnings in the US continued substantially to rise while those in European did not. Several factors may have contributed to this, including differences in the way the indices are structured, as well as poorer business conditions in Europe or a weaker focus there on creating shareholder value.

When companies' profits are generally and significantly growing, investing is easier and company value literally grows before one's eyes. In the declining phases of the earnings cycle, things are much less clear-cut and a little more complicated. Hand in hand with this, however, there occur more marked price fluctuations, and these can be exploited. Here are several basic rules to which we endeavour to adhere in times like these.

The equity market is a market of individual titles

Just because the earnings of companies generally are decreasing does not of course mean that profitability of all companies is falling. Even in this phase of the earnings cycle there are plenty of companies which are still growing their earnings – and sometimes by quite a lot. At such a time, however, investing requires very careful selection of individual investments. In a strongly bullish market, it oftentimes scarcely matters what one buys because everything an investor touches goes up. This is not the case today. Most equity prices have been below their highs for the past year and a half, often by tens of percentage points. The European index is about one-quarter below its all-time high while the US index is only barely so, although it should be said that the latter is held up by a handful of large (and also not very profitable) companies, and beneath the surface there lurks a skulking bear market.

The US market as a whole is trading on a P/E of 24.2 if its current level is measured against the last known earnings from March 2016. Although this is a relatively high multiple, not all equities are this expensive – not by a long shot. The situation can look quite different if we exclude all those companies having large weightings in the index but almost no earnings (Amazon) or only rather small profits (Facebook), as well as companies that are perpetual loss-makers (Salesforce, LinkedIn, Tesla) and the entire energy sector, which is currently in loss and has a 7.4% weight in the index. After stripping these out, what remains is far less expensive. Then, too, the European stock market is always open to us, and it is much less costly as a whole.

Numbers quality

When profits go down, company managers have stronger incentive to cook the numbers. Almost every company today reports two sets of numbers – one according to the accounting standards (reported earnings) and the other according to its own, frequently very loose rules (operating earnings). Operating earnings exclude a number of expenses that, according to the managers, conceal (i.e. decrease) a company's real profitability. Although management's proclaimed objective is to provide investors with a clearer picture of the actual profitability, in fact this is almost exclusively an effort to make themselves look better. The most frequently excluded expenses consist of what are termed one--time, extraordinary, and restructuring expenses but which in fact recur more or less every year; remuneration to employees paid in shares which are said not to be expenses at all; and one-time asset-value write-downs which are in fact admissions either that past reported profits were overstated or a promise that future profits will be overstated.

To illustrate how much the reported and operating profits differ, consider that while the most recent reported earnings per share in the US were USD 86.44 (as noted above), the most recent operating profits were USD 98.61. The difference is 14%. In many

companies, this difference is even much greater. Meanwhile, there are a number of other companies which do not engage in such manipulation. In any case, we at Vltava Fund always make our own judgement regarding a company's true profitability and take care not to be misled by what management tells us.

Reasonable expectations

Most entities involved in capital markets have a predisposition towards unreasonable optimism. This can be due in part to people's natures, but also it can have a lot to do with looking out for one's personal gain. Managements often tend to present the situation and outlook of their companies as better than they actually are, doing so not only because their own remuneration depends on investor expectations but frequently so, too, do the companies' operations, results, and sometimes even their survival. Analysts and brokers are usually overly optimistic, as well. Sometimes they themselves believe the overly rosy scenarios which they portray, but sometimes they embellish things intentionally because it brings in the business.

Again to illustrate: a year ago, the consensus of analysts' earnings expectations for the first quarter of 2016 was 29% higher than what it turned out in fact to be. The consensus earnings forecast for the full year 2016 was 18% higher a year ago than what it is now. For the full year 2017, analysts expect 17% growth in earnings. Both of these estimates will probably prove to be unreasonably optimistic.

Although we do not have our own forecasts as to the profitability of the market as a whole, we do of course make our own estimates for those companies we own. We currently estimate the overall year-on--year increase in earnings among our companies will by approximately 5%. Whether we are overly conservative or much too optimistic, we will see in a year. It is very probable, however, that the error in our estimate will be much less than that of analysts collectively for the market as a whole. We had similarly modest expectations a year ago, and these proved to be relatively accurate. Today, three-quarters of the companies in our portfolio have higher earnings per share than they did a year ago.

Long-term thinking and patience

A company's value depends upon the entirety of its long-term future, which means that profits in the latest quarter and even year influence it only minimally. Nevertheless, the stock market mostly responds – and sometimes very much unduly so – specifically to changes in earnings in the latest or current period and ignores long-term value. This creates excellent investment opportunities and gives rise to possibilities for a certain kind of time arbitrage. An overwhelming majority of market participants are under pressure due to their business orientations or competitive environments to achieve good results within short time horizons of days, weeks, or maybe two to three months. This compels them to pursue speculative moves offering them at least a little hope of immediate profit while at the same time completely forgoing investments where there is low hope for momentary gain but the probability of attractive long-term profit is high. It is precisely opportunities of the latter sort which we pursue. This requires patience, however.

For example, we have one title in our portfolio the price of which is not even half of what we believe is its value. The company is regularly and massively buying back its own shares. This year it is going to acquire nearly 20% of its own equity. It then cancels the shares which it buys and the other shareholders see the proportions of their ownership stakes increase. It is interesting that not only does the company not need to borrow money for these purchases but its own debt is diminishing at the same time. If it can acquire its own shares for less than half their value, then with each share it purchases the value of the remaining shares outstanding increases nicely.

If we carry this situation forward ad absurdum, then after 5 years of acquiring its own shares at the current rate and at the current price we would be the sole remaining shareholders and our share would have a value of several billion dollars. This is not going to happen, of course, because in the meantime there would occur such a huge gap between the share's price and its value that the price would have gone up long before this. We do not know when this will happen. One might say even the current difference between the price and value is so large that one must be blind not to see it, but the price has not yet responded. We do not mind this at all, however, because the longer the price stays low the more shares the company buys back cheaply and the more the value of the remaining shares increases.

Of course, there remains the possibility that it is us – and not the market at all – who has gotten it wrong. We realise this, but on our side there is such a great margin of safety in the form of the price–value spread that the probability of a good outcome is substantially skewed in our direction. Moreover, we have additional companies in the portfolio which are regularly and over the long term buying back their own shares, even though those are not such extreme cases.

Growth and its price

In times of generally dwindling earnings, earnings growth in individual companies is rarer and investors tend to overpay for it. We strive to avoid this, because it is apparent that **not all growth creates value**. There are a number of examples of companies that grow in terms of sales and perhaps even earnings despite that such growth does not create value. The market sometimes looks only skin-deep and it often will push up the prices of those shares even for quite a long time. A day of reckoning will someday come for such companies, however, and we do not wish to be in attendance for that. **Even growth which does create value can justify only a certain, limited price.** Investors often pay much more for growth than it is in fact worth. This we also avoid. We always endeavour to measure price against value. Buying growth at all costs would be a mistake, and sometimes even a company whose earnings are diminishing over the long term can constitute excellent investments if their share prices correspond to what is actually happening.

Everything passes

Everything that cannot last forever must one day come to an end. This phase of declining earnings, too, must pass and a phase of rising profits will begin. It would be marvellous to know when that day will come, but that would be too much to ask. It is possible that day was in the first quarter of this year. Earnings should be higher in this quarter due to a contribution from the energy sector, but you know how things can go when making predictions…

At current profit levels among US companies, their overall return on equity (ROE) is 11.6%. This is less than the long-term average, and it means that the capital companies presently have invested in their businesses should earn somewhat more than it does now. This would also signal higher earnings in future.

Changes in the portfolio

We sold out two positions, both for similar reasons.

Greenlight Re is a reinsurance company the investment portfolio of which is managed by David Einhorn, one of the best investors of the current generation. Our investment thesis was founded on the combination of a solid reinsurance business, good results for the investment portfolio achieved with a small exposure to the market, and the company's willingness and ability to buy back its own shares in case their price would markedly drop below the level of their fundamental value. As time passed, cracks began to appear in our assumptions.

Last year was a bad investment year for David Einhorn. You could say it was even worse than in 2008. This sometimes happens to even the best of investors, and we do not believe that he would all at once have lost his investment abilities. In our eyes, 20 years of good results carries more weight than does 1 bad year. Nevertheless, we were dissuaded by something else. Recently, there has been an increasing number of cases when we did not understand the reasons for some of his investments. We are conscious of the fact that the error could be at our side. After all, Einhorn is a legend and we are still rookie investors of some local importance. Nevertheless, we do not regard it as proper blindly to believe in something without understanding why.

Another reason is that the entire reinsurance sector is facing – and apparently will be facing for a long time into the future – low returns due to there being excess capital deployed in that sector. Finally, there was the realisation that when at the end of last year the shares of Greenlight Re were trading significantly below book value the company could not properly utilise this opportunity to repurchase its shares because, being a reinsurance company, it also had to maintain its capital levels as necessary for covering insurance liabilities.

Therefore, we decided to sell the shares. We lost 14% on the investment. This is the first title among those we bought in the past 5 years which we sold out of at a loss. Even though we endeavour that all of our individual investments will be profitable, sometimes it is better to accept a loss and redeploy the money elsewhere.

Oaktree Capital is an assets manager specialising primarily in bonds of various types and qualities. It is probably the best firm in the world within its field, and we have great respect for it. Nevertheless, its future returns will be substantially and negatively influenced by persistent low interest rates. It will be better to invest our money elsewhere. We earned 41% on Oaktree.

We bought two new positions – one in the US and one in the UK. We were most active at the very end of the quarter, when the sharp market reaction to Brexit brought great dislocations in equity prices due to a combination of the initial shock, stop-loss orders, and forced sales. In our opinion, Brexit will be seen in hindsight as a good buying opportunity, just as was the first Greek crisis 5 years ago.

On behalf of the entire Vltava Fund team,
I wish you a pleasant summer.

Daniel Gladiš, July 2016

AN ATTEMPT AT A SMALL GLANCE INTO THE FUTURE

Dear shareholders,

In the third quarter of 2016, the Fund's NAV grew by 6.6%.

Prophecy at the stove

"Young man, have you ever seen a mine? It's a hole in the ground, shafts going up and down and side to side. Now, a mine can be flooded, it can collapse, but no one can take it away!"

Every Czech knows this splendid excerpt from "The Visionary", an absurdist one-act play by the great (albeit entirely fictional) Czech playwright Jára Cimrman. (We also know today, by the way, that even a mine can be taken away.) At the centre of the action, the farmer Hlavsa is foretelling the future from peering into a red-hot stove to the Prague coal baron Ptáček. We have often said to one another that it would not be a bad thing to have such a stove for reading financial markets. Although we unfortunately do not possess one, let us at least imagine what revelations we could expect to find there.

Revelation one: indebtedness

Every consideration as to long-term global development should probably start with a look at the key countries' indebtedness. The following table shows the development of national debts as a proportion of GDP in major developed economies between 2006 and 2015.

Table 1 - Key countries´ debts (% of GDP)

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
US	63.9	64.8	76.0	87.1	95.2	99.4	100.8	101.1	102.9	104.1
Japan	166.8	162.4	171.1	188.8	193.2	209.4	215.4	220.3	226.1	229.2
Germany	66.4	63.6	65.0	72.5	81.0	78.4	79.6	77.2	74.7	71.2
UK	42.4	43.5	51.7	65.7	76.6	81.8	85.3	86.2	88.2	89.2
France	64.4	64.4	68.1	79.0	81.7	85.2	89.6	92.4	95.3	96.1
Italy	102.5	99.7	102.3	112.5	115.3	116.4	123.3	129.0	132.5	132.7
Spain	38.9	35.5	39.4	52.7	60.1	69.5	85.4	93.7	99.3	99.2

Source: www.tradingeconomics.com

The US, for example, had a national debt equal to 64.8% of GDP at the end of 2007, which in hindsight was the last relatively calm year before the Great Financial Crisis. A mere 2 years later, which is to say just after the crisis, the debt was one-third higher, at 87.1% of GDP. At the end of last year (i.e. after 6 more years of "economizing and saving"), the debt was higher by another one-fifth: 104.1% of GDP. In just 8 years from 2007, it grew by an incredible 61% and the debt continues to increase.

The development in other countries has been in the same direction. The most indebted by far is Japan, and debt is growing the fastest in Spain and in the UK. Only Germany slightly defies this trend. Although it, too, has a high debt, Germany's debt is the lowest among those countries listed and it has been decreasing for several years (a question remains as to how much of a negative effect will occur due to the mass influx of immigrants). It is interesting that the unexpected crisis in 2008 increased the debts by an average 29%, and the following 6 years of economic expansion, low interest rates, and massive pro-growth stimuli brought another 29% rise. This is an incredibly alarming state of affairs. Debts have not been diminished successfully even under the relatively favourable economic conditions.

Why are debts a problem?

In the Czech Republic, we have heard politicians proclaim that "debts need not be repaid" and "there are sources enough". But that is absolutely not the case. Long-term deficit operations and amassing debts is possible only until the market is no longer willing to finance it. Once the market's willingness breaks, a swift end must follow. We need only go back to the book by Reinhart and Rogoff entitled This Time Is Different to be reminded of dozens of similar examples from history. The problem is that it is impossible to estimate beforehand at what level of indebtedness the market will lose confidence. Moreover, this level is not the same for every country. If the market is still able to tolerate Japan's national debt at the level of 229% of GDP this does not mean that other states can count upon the same. Many countries in the past have been forced to declare bankruptcy with debts at only a fraction of that level. According to Reinhart and Rogoff, more than half of state defaults were at debt levels under 60% of GDP.

If we consider that national debt constitutes a substantial burden on state budgets, diminishing governments' room to manoeuvre, pushing out private capital, suppressing economic growth, and raising the risk of potential insolvency, it is evident that debt and its size are potentially a great problem. The current debts of the major developed countries are simply too high, even leaving aside questions as to their immense future liabilities primarily for pensions and healthcare. These debts are not included into measures of the national debt – but they should be. Companies which have pension liabilities to their employees must state these on their balance sheets. They must measure and continuously finance these debts according to certain rules. If the same measures were to be applied to state finances, we would be shocked at how high are these debts. In many countries, their national debts would multiply several times over!

If you have masochistic inclinations, you can read the article by Jagadeesh Gokhale, formerly a senior fellow at the Cato Institute, entitled Measuring the Unfunded Obligations of European Countries. Gokhale has long been examining this problem, and according to his calculations the present value of future uncovered liabilities in the EU is on average 434% of GDP! Spain is the best off, at 244%, while Poland is in the worst shape with a figure of 1,550%! These numbers are downright terrifying. Moreover, those figures are from 2009. They will be even higher today, as the debts have continued to grow and the interest rates used to discount future liabilities are lower.

There can be no doubt that debts are too high and must be somehow reduced over time. So far, the only thing governments have to show for themselves is their endeavours to resolve the debt problem by amassing still more debt. Isn't that great! It is as if an alcoholic can be treated by ever larger doses of alcohol. Warren Buffett at one point, probably with a bit of exaggeration, proposed to resolve the problem of swelling US indebtedness by enacting a law forbidding any politician who ever voted for a deficit budget from re-election. I would agree. That would solve a lot.

How to decrease debt?

The size of the debt relative to GDP can be reduced in essentially three ways. The first is by rapid economic

growth. A briskly growing economy puts a smaller burden on the budget, and GDP can grow more rapidly than the debt. Thereby, the growth in debt relative to GDP can diminish. This is the ideal scenario, of course. Unfortunately, it is practically out of the question for most developed economies. If we look back to the previous table, we probably would not be surprised to see that the debt of the selected countries increased by 29% over the two worst crisis years. This could have been expected. An unpleasant finding, however, is that even though the global economy operated in a relatively favourable climate over the past 6 years, indebtedness has continued to grow relatively quickly.

Economic growth is still too slow to decrease debt all by itself. GDP growth in developed economies has been slower since the Great Financial Crisis than in any other equally long period since the Great Depression at the turn of the 1920 s and 1930 s, the growth in productivity has been the slowest since the start of measurement, and corporate investments still remain below their long-term average. In my opinion, the main reasons for slow growth are the government role in the economies that is too great and still expanding, incredible bureaucracy, omnipresent regulations, too--low interest rates, and the very magnitude of the national debts. Debts in most countries are simply so high that they very nearly thwart rapid economic growth altogether. Debt will definitely not be reduced in this manner.

The second possibility is to write off the debts, and the third is to let them be erased through inflation. The stove clearly portends the latter, and we will come back to that in a moment.

Revelation two: interest rates

If we were to have a single piece of advice for future generations of financiers, I would recommend for this message in a bottle to be: "Do not touch interest rates!" If there is a quantity in economics that can be denoted as crucial it is the price of money. If this is kept at the equilibrium value as determined by the market it will well reflect the relationship between supply and demand for money, allow risk to be evaluated correctly, and allocate resources properly. If, however, interest rates are so deformed by massive central bank interventions as they are today, then not only will rates fail to fulfil these roles but they also will cause extensive damage and give rise to unexpected negative side-effects.

We see something similar in physics. If we move at relatively low speeds, then we can practically consider mass to be constant and time to be flowing at a constant rate. If we reach very high speeds, then mass grows with increasing speed and time slows down. The original relationships cease to be valid. It is the same in finance. If a negative sign appears before a number representing interest rates, then we enter into a different world.

It is precisely into such a world that we have been led in recent years by the policies of large central banks. (Central banks of small countries such as the Czech Republic are pulled in the wake of decisions by the large countries' central banks to such a degree that blaming them for the current state would be unfair.) The first and most visible response to the Great Financial Crisis by central banks was to cut rates. The basic supporting argument seems rational at first glance: Lower interest rates support economic growth. If we talk about normal levels of interest rates (as we do of low speeds in physics), this apparently works. But when we get to rates that are nominally around zero or even below zero, and in real terms deeply negative (equivalent to high speeds in physics), then the effects are different.

Today's level of interest rates is markedly damaging the economy and hindering its growth. Abnormally low interest rates decrease consumption as they force people to save larger portions of their incomes because returns from savings are low. Abnormally low interest rates diminish banks' profits, have a negative effect on their capital strength, and thereby reduce their willingness and ability to lend money. In contrast, economic growth depends upon the availability of loans, and without credit expansion the economy scarcely grows. Abnormally low interest rates decrease interest costs on national debt and therefore provide governments with a false sense of security and comfort. Governments love this situation, because it facilitates what they do best – putting problems off to be solved in the future. A Pyrrhic victory. Last but not least, abnormally low interest rates cause risks to be evaluated improperly and – partially by intent and partially by inescapable forces – assets to be allocated inefficiently.

Dead end

When I look around it seems the only ones who do not see this state of affairs or refuse to admit it are the central banks themselves. For example, when the Bank of Japan introduced the –0.1% rate for bank deposits in the spring, the share prices for all Japanese banks fell by nearly one-half almost overnight. The ECB for its part repeatedly declares how its negative rates are helping European banks. One only has to look at the development of profits, returns on capital, and European banks' share prices to see that exactly the opposite is true. Wherever one looks one sees the harmful effects of low interest rates. How is it possible that central bankers do not see this?

My purely private and unsubstantiated opinion is that they do know this but must not admit it in public. And who would voluntarily admit that they had led their country into a dead end? Normalising rates is not at all simple, and in many cases it is not even possible. What rates are normal? To take an example, if inflation is 1% then short-term rates cannot be zero. Short-term rates must be positive in real terms, let us say 2%, and long-term rates should be at least 3–4%. Even such historically low rates would bring immense financial difficulties to certain countries, however. For example, Japan has a debt of approximately 230% of GDP. A rise in rates by 1 percentage point would mean an increase of interest expenses equal to 2.3% of GDP annually (of course not immediately but rather gradually as the old debt would be continuously refinanced) and rates higher by 3 percentage points would mean interest expenses would grow by 6.9% of GDP annually. That is more than the current annual budget deficit, which is high already. Japan's current budget outlays are 62% greater than revenues (see the following table), and a rise in interest rates could cause a complete collapse of state finances. Other large developed countries are in similar positions. Their central banks see this, of course, and therefore they must keep the rates low come what may.

Table 3 – Budget deficits

	Government revenues	Government outlays	Outlays/ revenues	Deficit/GDP
US	2,100	2,907	138 %	2,50 %
China	14,770	17,576	119 %	2,30 %
Japan	59,479	96,342	162 %	6,00 %
Germany	1,302	1,272	98 %	(0,70 %)
UK	673	742	110 %	4,40 %
France	155	194	125 %	3,60 %
Italy	49	61	124 %	2,60 %
Spain	416	465	112 %	5,10 %

Doubling up the bets

The longer rates remain at an artificially maintained low level the more damage they cause. In the end, central bankers will have to come up with something new. Practically the only thing remaining is to launch massive fiscal stimulation programmes together with the government and to finance these by newly issued money. Here is what this might look like: The government thinks of some infrastructure project (these always look good on paper and their effectiveness cannot be measured), but rather than the money coming from taxes, as usual, it will be issued by the central bank. Or, for example, every citizen will get a cheque for EUR 500 from the central bank that needs to be spent within three months. It sounds crazy but debates about the form of these stimulus measures have actually been ongoing for a long time.

Politicians will immediately realise that they have discovered a perpetual motion machine. They will be able to spend money without needing to have taken it from someone. This is Nirvana to them, and once they start they will not know when to quit. On the income side there will scarcely be anyone to complain. Unfortunately, however, these stimulus actions cannot boost overall economic growth and society's wealth over the long term. This was beautifully and logically explained by Henry Hazlitt in his great book Economics in One Lesson from 1946. As you can see, this topic has been discussed for quite a long time already.

Revelation three: growing inflation

A probable side-effect of fiscal stimulus programmes financed by issuing money in combination with ultra-

-low rates will be accelerated decline in the value of money and higher inflation. Here is where push comes to shove. Textbook tools for fighting inflation – i.e. primarily raising interest rates and limiting growth of the money stock – will be unusable. Or better said, they could be used but only at the price of dramatic recession and impending collapse of state finances in some of the most indebted countries. The world simply cannot afford high interest rates due to the size of its debts. A question is whether central banks do in fact have such control over those rates as they try to pretend today or if they eventually will be overwhelmed by the market and relegated to an observer role.

In any case, central banks will have their hands tied for fighting inflation and will need to tolerate a combination of higher inflation and lower interest rates. Interest rates will be negative in real terms over the long term, as they actually are already in many places. That condition will just be much more pronounced than it is today. This will allow governments to survive even with immense debts, and it is also possible that due to high inflation brisk nominal GDP growth will allow the debt to decrease. Such situation will, however, have enormous consequences. Some might even like the situation as negative interest rates allow for reducing debt generally, but this will be paid for dearly by eroding the real value of people's savings. This actually is occurring already today. There is a huge transfer of property from the private sector to the state. The population's middle and lower classes are the ones primarily affected, and I do not understand how it is possible that people are not revolting against this.

The main objective for us as investors, however, is not to change the world but rather to try our best to invest within the conditions existing in our world and as they will exist in future. If we accept the thesis that we can expect a period of negative rates in real terms, then let us think how the basic asset classes may fare in such an environment. History as well as the world today provide us with certain guidance.

Historic returns

In one of my previous letters to shareholders entitled Risk-free Stocks, I used a graph from Jeremy Siegel's book Stocks for the Long Run which clearly shows that stocks not only provide the highest returns by far among assets – significantly exceeding those from bonds, bills, gold, and cash – but also that they have surprisingly the lowest deviation from their long-term trend. These are hard historical facts and thus scarcely worthy of discussion at length. There remains a question, of course, as to whether the future will be the same as the past. I am well aware that many predictions about the future will very soon be proven erroneous, but it is very probable that relationships between the real rates of return for the basic asset classes will be preserved.

If real interest rates will remain at an artificially low level, then real returns of other asset classes will accommodate this and will also move lower. Cash will still be the worst asset to hold over the long term, however, and stocks will be the best. Capital lent to someone for business purposes (e.g. a bank deposit or a bond) must over the long term bring a lower rate of return than capital invested directly into business (i.e. stocks). This has been the case in the past, and this should also be true in the future. The opposite situation would make no sense. If lending yielded better returns than did equity capital, then everyone would want to loan money to companies but no one would establish them.

Where is wealth created?

Recently, I got the idea to look at the list of the wealthiest people in the world according to Forbes and determine where their wealth had come from. Of the 50 richest people in the world, 48 had made their fortunes in stocks, and 2 in real estate. There is no one there who would have become breathtakingly rich by holding cash or gold or by purchasing bonds. Real wealth is produced in companies for the shareholders who own them, and it does not matter whether these are publicly traded companies such as Walmart, Amazon, or Berkshire or privately held companies such as Bloomberg and Aldi. The economic impact for their owners does not depend on whether or not the companies are traded on a stock exchange. Publicly traded stocks provide one way to obtain equity shares in companies, and it is a relatively easy way that is available to all.

A few years ago at Berkshire Hathaway's annual shareholders meeting, Warren Buffett talked about

what instructions he had put into his last will and testament concerning the handling of his private portfolio beyond his Berkshire shares. These are very simple. The investment is to be made thusly: 10% cash and 90% stocks. I am not saying that we all need necessarily to agree with Buffett, but if you believe, dear reader, that Buffett is making a mistake, then the burden of proof is on your side.

Lesson from other countries

In the past 15 years we have been living in an environment of unusually low inflation (with the exception of such countries as Argentina, Venezuela, Zimbabwe, and just recently Russia), and it is easy to get the impression that this is a new norm, a new permanent state, that this time will be different from the past. The past, however, clearly shows that such calmer periods do not continue indefinitely. The question is not whether inflation will rise, but rather how much will we let it take us by surprise.

If inflation starts to increase, this will have a dramatic impact on the real value of various asset classes. A look at history will suggest how the individual asset classes will fare. A nice example is provided by Israel, a country which in the 1970 s was in a situation such that it had committed to large military and social outlays and was unable to bear them. Israel sought the solution in monetizing debt, and the result was inflation between 1972 and 1987 which pushed up aggregate prices by 10,000 times. The stock market index rose by 6,500 times over the same period. Although stocks did not maintain the real value of money, they did as a class fare incomparably better than did cash or bonds. The real value of these was completely annihilated.

Similar conditions of long-term high inflation occurred, for example, in Brazil, Argentina, Zimbabwe and the Weimar Republic. Among the investment assets described above, only stocks provide a path to survival in times of high inflation.

Three final questions

What I have described above will give rise to three basic questions in most anyone's mind: How probable is the described scenario? How high can inflation go? When will all this happen?

Of course, no one knows precise answers. As to the question of probability, I would say this: If any of you have an idea how it could happen that labour productivity would begin to rise at a faster rate, the negative demographic development would reverse itself, and states would diminish their role in the economy, return to the roots of capitalism, and start to demolish growth-stifling regulations, and if all this causes a dramatic acceleration of economic growth such that it allows for reducing the size of the debt relative to GDP, that at the same time there is a new and qualitatively higher type of politics refusing to amass debt, and that central banks withdraw substantially to the background and let the market be the market, then send it to us. I would be very glad to admit to being wrong! If not, however, I am afraid that the aforementioned scenario is very probable.

How high can inflation go? I would be very much surprised if inflation remains at just single-digit rates. Japan in particular, paradoxically a country that has not seen inflation in 20 years, is the first candidate for double-digit inflation. The Japanese government and central bank are presently trying hard to achieve at least 2% inflation, and so far they have not been successful. Considering their resolve and practically unlimited possibilities they will eventually succeed, but I am afraid that the idea of inflation obediently stabilising at the 2% level will very soon be dispelled. Once the breaking point occurs in people's thinking, in the development of the currency exchange rate, and in the willingness of the market to finance the debt, inflation will on the contrary reach nightmare proportions.

The most difficult question to answer is when it will happen. Again, history teaches us that a situation usually looks stable for a long time before there is a breaking point from which there is no turning back. This moment will occur. It probably will strike very suddenly and dramatically. Unfortunately, it cannot be said whether it will happen next week or in 15 years. A long-term investor should prepare his or her investment portfolio in due time. It will be too late after we cross the breaking point. Stocks must play a large role in this "prepared" portfolio.

Everything described here we saw in the stove, but it may not mean anything at all. Perhaps it will turn out differently. On the other hand, as Hlavsa said: "Everything that the stove showed always came to pass."

Changes in the portfolio

We sold Oracle. We had held Oracle for several years, albeit with a small break when we had sold it only to buy it back soon thereafter at a much lower price. Our return for the first time was 18% and for the second time 33%. In total, therefore, approximately 57%. Considering the length of our holding period, it was a below-average investment that lagged behind our expectations.

From an historical perspective, Oracle's main business has been in its database systems. These were installed directly at the client's site. This was both labour- and cost-intensive and erected sizeable barriers against the customer's shift to another supplier. This was the source of Oracle's great competitive advantage, and the size of its profit margins corresponded to this fact. Today, increasingly larger numbers of licences are not installed directly at the customers' sites but are accessible in the cloud. This arrangement substantially lowers the barriers against changing the system and the supplier's competitive advantage. That means profit margins will undoubtedly be substantially lower in the future. Oracle is itself feeling this already, and therefore we preferred to get out of the stock.

The response of markets to the UK referendum brought several irresistible opportunities. Among other things, we took advantage of this situation to open one new position. It is an inconspicuous but very profitable Irish company. If only there would be several such Brexits every year…

Daniel Gladiš, October 2016

THE US ELECTION AND THE KELLY CRITERION

Dear shareholders,

In the fourth quarter of 2016, the Fund's NAV grew by 8.4%.

The biggest event of late last year was the US presidential election. As the election date approached, we were flooded from all sides with advice and tips on how to make the best investment bet on the result. The majority of investment recommendations appeared very confident even though, as is usually the case, hindsight has shown them to be erroneous. It would be a mistake, however, to evaluate individual investment decisions according to their outcomes. A correct investment decision is not one which brought a positive outcome but one which was made according to a proper method at the given point in time and with the information then available. We believe it would be an error to make investment bets on the outcome of the elections in the first place. We therefore executed no transactions in our portfolio prior to the elections which would have speculated on their outcome. We have both theoretical and practical justifications for this approach, and I would like to explain them in this letter. I will nevertheless come to that explanation by a somewhat circuitous route.

Edward Thorp

I recently had the opportunity to read the manuscript of a book entitled *A Man for All Markets: From Las Vegas to Wall Street, How I Beat the Dealer and the Market*. This book will be published early this year and it is Edward Thorp's autobiography. (If you want to read it, you may prefer to skip the rest of this section.)

Edward Thorp is one of the greatest investors in history as well as an extraordinarily interesting character. Judge for yourselves: Thorp was a student of mathematics who demonstrated how to apply mathematics in many areas of everyday life. He invented card counting and discovered the apparently impossible – how to beat the dealer in blackjack – and he practiced this very successfully. He played in casinos,

oftentimes visiting them in disguise. After having been discovered and banned from casinos, he described it all in his first best-seller *Beat the Dealer*.

He then redirected his attention from cards to roulette and figured out how significantly to beat the casino also in roulette. This sounds incredible, because everyone knows that the winning odds in roulette are theoretically in the casino's favour. Not necessarily so in practice, however. Thorp realised this and put his findings into practice using the first wearable computer. Casino owners were livid, and Thorp began to fear for his life. He therefore left casinos to their fate and thought about which field would provide him with plentiful room for his further intellectual enjoyment. He chose the capital markets and stock exchange. Thorp was a forerunner of quantitative investment methods, a pioneer of convertible arbitrage, and the actual first author of the option pricing method for which Merton and Scholes were later awarded a Nobel Prize. He described his investment practices in his next best-seller, *Beat the Market*. Above all else, he was not solely a theorist but also a practicing investor. His hedge fund Princeton/Newport Partners achieved an average annual return of 19.8% in the 19-year period between 1969 and 1988.

Thorp also was an early investor in Warren Buffett's Berkshire Hathaway, and 17 years before the cover was blown off fraudster Bernie Madoff's scheme Thorp already had demonstrated by way of fictitious results and trades that Madoff was a crook.

Kelly Criterion

Whether it was about cards, roulette, or stocks, all of Thorp's activities had one common denominator. He was always working in an environment where he endeavoured to find an optimal size for repeated investments (or bets) for a given set of investment opportunities with various expected returns and various probabilities for their occurrence. He often utilised the Kelly Criterion, named after its author, the physicist John Kelly:

$$f = \frac{p(b+1)-1}{b}$$

where:

f is the part of portfolio which should be placed into the investment,
b is the ratio of the return on investment, and
p is the probability of winning.

For example, if there is a 60% chance of winning (p = 0.60) and the investor makes 10% (b = 1.1), he or she should invest 24% of his or her portfolio in this manner. If the probability of winning increases to 70%, he or she should invest 42% of his or her portfolio, and if the expected return increases to 20% with a 60% probability of winning, he or she should invest 27% of the portfolio.

Generally speaking, the Kelly Criterion offers a good indication for how to calibrate individual investments. If we find an investment which we believe promises a solid expected return and above-average probability of its being achieved, then we must not hesitate and must invest a goodly amount. When you tinker a little with the parameters in the formula, you will find that the size of the investment is influenced more by the probability of success than by the expected returns. Investors frequently make the mistake of being attracted by high potential returns while underappreciating their relatively low probability. We should avoid such investments and instead seek investments where the expected return may not be staggering but has a high probability of occurring. This is what the Kelly Criterion teaches us.

Application to the election

In our investments, we also take into consideration the Kelly Criterion. We are aware that investing is not a natural science and therefore we do not know the precise probabilities of phenomena or precise expected returns. We know that the estimates with which we work will always be imprecise and subjective. These are limitations integral to investing and which cannot be eliminated. More important is to be aware of their existence.

So how does this theory apply in practice, in the specific example of the US election? Although polling just prior to the election favoured Hillary Clinton, the polls were so close that considering statistical margins of error or even the possibility that the polls might not be objective, the probabilities for the voting outcome were essentially 50:50. In the case of such probability, the Kelly Criterion advises that it is better to do nothing at all.

But that's not the end of it just yet. We still have to estimate the expected return, which in this case consists of the market move based upon the election results. Estimating this is essentially impossible. It is one thing to estimate the expected yield of an investment as its future cash flow, but reliably estimating investors' response to a certain event is something else altogether and is wholly impossible. The most frequent prognoses before the elections said that the market would respond positively to a Hillary Clinton victory and negatively to a Donald Trump victory. We know how this actually turned out. When it appeared right before the election that Clinton's chances were improving, the market was rising. Then, when perhaps unexpectedly Trump won, the market rose even faster.

So what cards did we have in our hand ahead of the elections? Even odds of the candidates' winning and zero ability to foresee the market response. Only one thing can be done in such situation – nothing. And that is precisely what we did.

This situation has an additional, perhaps paradoxical point. Prior to the elections, we had believed that Trump would win and that the markets would respond positively to this. Some pre-election proclamations from Hillary Clinton and Senator Elisabeth Warren were so anti-business in their orientation that we thought to ourselves the market would breathe a sigh of relief when it avoids the worst by a Trump victory. Today, knowing how things ended up, we paradoxically would have made more if we had reflected our pre-election expectations into our portfolio. That, however, would have been a mistake. We do not want to expose our portfolio to random phenomena for which we have no basis in our own analyses or try to make money due to sheer luck. We realise very well that this all could have turned out entirely differently.

We cannot say for certain why the market went up so much just after the election. There is an apparent connection to the election result, but this could just as well have been a random development. We will never know what the market would have done in the case of a Trump defeat. Perhaps it would have behaved in the same manner, perhaps it would have gone down, but it could also have jumped up even much more markedly. People often try to find causative links in the way things turn out, but there may not be any significant relationship at all or those that do exist may be entirely different. We realised this even before the election, and therefore we held back. We had behaved similarly ahead of the UK referendum about staying in the EU, and we intend to maintain the same stance also in cases of similar events in future. We invest only when we believe the probability of success is markedly skewed in our favour.

Changes in the portfolio

Although we were rather in hibernation prior to the elections, we were much more active afterwards. This was not because we had changed our opinions about the future or about the companies we own. After all, we like the same companies after the elections as we did before. It is more about pronounced movements in share prices in the post-election weeks and how they changed the ratios between the prices and values of the individual stocks.

We sold shares of Servis1stBank. Their price went up so much after the election that in our opinion it exceeded the company's value. Such a company will not hold its own either in absolute terms or in relative terms compared to other investment opportunities. After holding the stock for 14 months, our return was approximately 67% and we are very satisfied with this.

We have one addition to the portfolio. It is a US company in the health care segment. Health care did not fare well in the after-election price tumult, and therefore the share price of this industry leader reached a very attractive level. In our opinion, it is an above-average company with a solid competitive advantage and is available at a below-average price. It is possible that it will remain in our portfolio for a very long time.

Wishing you all the best for the New Year

Daniel Gladiš, January 2017

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