VLTAVA FUND

Dear shareholders

Vltava Fund's NAV per share grew by 18.5% in 2014, and assets under management reached 1.9 billion Czech korunas as of 31 December 2014.

Our largest equity positions at the start of 2015 were Berkshire Hathaway, WHSmith, Catlin Group, Walmart and Teva Pharmaceutical. These are the same companies as from a year ago only in a slightly changed order. Our portfolio is concentrated into investments which 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 70% of our portfolio.

In the current market, the Fund's portfolio is priced at about 12 times the earnings of the past 12 months. This means that for last year the net profits of our companies amounted to approximately 8% of their market capitalisation (i.e. 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-tenth higher than their current prices. A fundamental valuation is not something static, however. Rather, it is developing through time. In the case of our portfolio, it is quite solidly growing. At the end of this year, it will be on the order of one-fifth higher than today's prices. This should create sufficiently strong upward pressure on the prices of our stocks to push them higher.

In the past six 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 to 4.6 times where it had been. More precisely, it has risen by 360%. While it is true that the past six years have been very good for equity investments, our results are nevertheless exceptional by worldwide standards. This result places our fund among the very top funds in the world.

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 best 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 six years.

In the next part of the Annual Report, 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.

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 2015

VLTAVA FUND

FORM FOLLOWS FUNCTION

Dear shareholders

In the first quarter of 2014, the Fund's NAV grew by 7.3%.

Form follows function

Once upon a time long ago (in fact, more than a quarter century ago), I entered the Faculty of Civil Engineering at the Brno University of Technology. That was still in the times of Communism, when essentially neither finance as a field of endeavour nor financial markets yet existed in our country. By the time I had completed my studies a year and a half after the Velvet Revolution, the world here had suddenly and completely changed. I left my five years of studies behind and set out into the fascinating world of finance.

It might appear as if my degree in civil engineering means nothing to me, because it was clear that I would not use it to earn my living. But all education has value in its own right, and even fields appearing to be completely unrelated can have a great deal in common. That may be true even of civil engineering and investing. Or, to put it more precisely, of architecture and investing.

At the close of the 19th century, the face of a great city had been taking shape in Chicago. While skyscrapers are typical for New York, it was Chicago which determined the direction in which they would develop. And so it was in Chicago at that time that the phrase "form follows function" originated and came into use. In architecture, it means that a given building's shape and structure should be determined by the function which the building is to perform. This was the fundamental idea from which the architectural style of functionalism would later evolve. Although the idea was fundamental, it perhaps was not wholly original, as similar reflections had been recorded already in the times of ancient Rome when Vitruvius had written that every building should be robust, useful and beautiful.

And what has all this to do with investing? The parallels ought to be clear. Every portfolio should take such form as properly corresponds to its function or its investment objective.

In order to achieve such a state, our first step must be to define the function that we want the portfolio to perform. In our case, the function can be stated, for example, as follows:

The portfolio's function is to deliver long-term, substantially positive real appreciation accompanied by minimal probability for permanent loss of capital.

Creating the form

This definition in fact encompasses three crucial functions of the portfolio:

1. **Long-term orientation**. Our objectives are unambiguously long term in nature. It can be said that we have no short-term objectives whatsoever, and, if we were to have such goals, we admit that we would not even know how to achieve them. In our approach, long-term orientation means at least several years.

2. **Positive real appreciation**. The investor's greatest enemy and at the same time his or her motivation is inflation. Day after day, it steals from the value of money. A function of the portfolio, therefore, must be to produce real returns, namely returns net of inflation.

3. **Minimal probability for permanent loss of capital**. This depends on more than just price but also on how an investment's value develops. It is precisely by choosing investments whose values grow over the long term (and acquiring these at low prices) that the probability for permanent loss of capital will be diminished.

Regarding individual classes of assets, the data clearly show that over the long term as well as over most medium-length periods equities are the assets which bring the greatest returns. If we define risk as the probability for permanent loss of capital (in real terms), then equities are also less risky.

Most people think exactly the opposite. People mostly associate risk with volatility, whether knowingly or unknowingly. So for them, equities appear to be risky and holding cash appears to be safe. Holding cash, however, brings the certainty of a permanent real loss

of capital. We want to steer clear of this problem, and so we create a portfolio the great majority of which is composed of equities.

Three portfolio levels

We segment our portfolio internally into three levels.

The conservative core (robustness). There exists only a small group of companies in the entire world which are wholly unique and practically cannot be replicated. All of these have some permanent, sustainable competitive advantage, and their businesses are so robust that they can thrive under almost any conditions. There are not many of these, and when there is a possibility to buy stock in one at a good price, that is cause for celebration. We own stock in four such companies comprising one-fifth of the entire portfolio. Their attractiveness derives mainly from their combination of expected returns and very, very low risk. We would sell the shares in these companies only under the most extreme conditions, such as if their prices were to rise so much as to become outrageously expensive. Another case might occur if a dramatic slump were to hit the entire equity market. In such instance, the share prices for our conservative core companies would probably decline by much smaller increments and thereby become a very rich source of cash from which to acquire other, momentarily much more attractive investments.

The value majority (usefulness). The majority of our portfolio is composed of shares in very high-quality, financially strong companies. The value of these companies grows solidly over time, and they are managed for the benefit of shareholders. By their quality these companies do not attain the uniqueness of those companies in the conservative core (of which there are truly only a few), but they generally stand just a bit below them. Their somewhat higher risk is balanced by their appreciably higher expected returns. The majority of the returns to our portfolio are generated by these very companies. We measure the anticipated holding period for these shares in years.

The opportunistic. From time to time, there appear in the market attractive investment opportunities in companies which, for reasons of their type and character, we would not want to hold over the long term. It would be a real waste, however, to ignore these opportunities, and so the smallest part of the portfolio is made up of just these cases. Sometimes there are more of these, sometimes scarcely any at all. It is not possible to plan this in advance, as it depends upon these opportunities arising and, above all, upon how successful we are in finding them. These positions have the greatest turnover, and indeed some of them remain in our portfolio for only a couple of months. The return, however, can be excellent.

Are you still missing the beauty in our portfolio of which Vitruvius wrote? We think it is there. We do not see beauty in a great multitude of transactions or in titles which soar, are sexy or represent some sort of fashionable social change. We see beauty in simplicity. In architecture, in music and in investing, the most beautiful things are ingeniously simple. We strive to achieve that beauty in our portfolio.

Changes in the portfolio

We sold three positions. Each has a story connected with it. Here they are:

General Motors is not really a company we would like to hold over the long term. Automobile manufacturers have many characteristics which we view negatively. This is a very capital-intensive business, which often means carrying large debts. The sector has chronic overcapacity globally, and it is very cyclical. So why, then, did we hold GM shares? GM once was a company which was good to sell short at any price. That was our opinion about it before the great crisis, and we were not alone in that. Mainly, this was due to its colossal indebtedness. GM went through bankruptcy during the crisis, following which, at the close of 2010, it returned to the market as a company of uncustomary financial strength and with the U.S. government as its majority owner. Whereas before the bankruptcy GM's balance sheet had been its acute weakness, on the other side of bankruptcy it had almost become its pride and joy. The market did not take proper note of this, however, and in connection with the expected large sale of the government's shares, it valued the shares unreasonably low. We therefore had put aside our distaste for automobile manufacturers and in 2012 had acquired GM. We have now sold it with a 70% gain.

Tesco is a stock we bought (most of the position) at the start of 2012 on the day when its shares recorded their largest one-day drop of all time. We were

pleased to discover shortly afterwards that Warren Buffet had purchased a 3% stake in Tesco on the very same day. Our investment proposition was as follows: The British market was dominated by four strong companies, the biggest of which was Tesco with a 30% market share. The preceding decade had been marked by sweeping growth in retail sales footage. The British market, however, was already more than saturated, and smaller investments would be required in future to support greater free cash flow. Tesco's new management, which had taken over in 2011, is not so tied into the history of expanding abroad, and we had expected that it would sell off some of its loss-making foreign businesses. Both of these expectations were fulfilled. Tesco began to slow its domestic expansion and free cash flow was able to grow. Tesco further sold off its American and Chinese businesses, both of which had been in losses for a long time. It would seem that everything is well on track.

Something happened that we had not expected, however. The long-standing tranquillity on Tesco's home market began to be disrupted by aggressive expansion on the part of the Lidl and Aldi chains. It gradually become clear that this could bring such pressure on margins that the big four would have no choice but to compete through lower prices. We believe it is already happening and that this situation will bring Tesco lower profits over the long term than we had originally expected. We therefore sold Tesco. Our gain was 9%. Although our original assumptions turned out to be incorrect, we nevertheless realised a favourable gain. This is especially due to the fact that we bought the shares at a truly low price. This created a large margin of safety and a price reserve to cover for even a mistake or future negative development. A large margin of safety is a fundamental element in our risk management.

Preferred shares in Fannie Mae and Freddie Mac.
Fannie and Freddie are among the symbols of the financial crisis and the excesses of those times. They are private companies whose obligations are guaranteed by the state. This combination entails a great moral hazard. The task of Fannie and Freddie was to support the housing construction market, in particular by guaranteeing mortgages. In 2008, the companies were under threat of bankruptcy, and they were taken over by the state.

This all occurred in an unusual manner, however, whereby the companies' legal structure remained intact. Fannie and Freddie had in circulation several issues of preferred shares which were not in any way affected by the takeover, with one exception: dividend payments ceased. As a result, the preferred shares were trading at one-tenth of their nominal value. From a long-term viewpoint, this presented a binomial distribution of possible outcomes. Either zero or one, as it were, and no possibilities in between. If Fannie and Freddie were to be liquidated, the preferred shares would be worth nothing and we would lose our entire investment. If Fannie and Freddie were to survive and wish to return to the market, however, then they would need to restart paying dividends to holders of their preferred shares and we would have grown our investment 10-fold. The return profile of the two alternatives was thus 10:1.

In view of the probable outcomes, this appeared to us an attractive combination, and we bought preferred shares in both Fannie and Freddie. Fully understanding the large speculative element, our initial position was small. For a while nothing happened, but when it gradually began to be clear what great profits Fannie and Freddie were achieving and how their role on the mortgage market was continuing to grow, then the probability also began to rise that neither company would be pushed by the state into liquidation. In response to this, the preferred shares saw tremendous price growth. We recently sold them with gains of 376% (Fannie) and 300% (Freddie). Their return profile had fallen from 10:1 and was approaching 1:1, and that was too risky for us.

We bought two new positions.
The first is in Russia.
What? Have we gone mad? Well, not completely.

Russia is not a foreign market for us. I myself made my first investment there in 1996, and the title that we just bought I had myself owned back in 1997. Since that time, I have followed the stock from a distance. Over the past two years, we have looked at it in detail several times. We always came to the same conclusion: although the price is very low we do not want to buy the stock because it is in Russia. At the same time, we were asking ourselves if we were not making a mistake. The Russian market is very unpopular among investors, and that is exactly why share prices are so low there.

When Russia invaded Ukraine, investors' distaste for Russia and the low prices of Russia shares shifted even one level further. A typical portfolio manager at a big bank or investment or pension fund considers it thusly: If I have Russian shares in my portfolio, that doesn't look very good. My superiors, risk managers and investors will ask me about them. Given the risk to my career, it would probably be better to sell them. Then no one will bother me about them, and people will leave me in peace.

If the majority of investors considered things in this way, then the market would be flooded with orders to sell Russian shares. And that is just what happened. So we bought a few. We kept our wits about us, though, and so this investment is very small. We think that the returns will be very nice.

The second position is in America. For most of the Fund's life, we have held a smaller or larger portion of the portfolio in bank deposits. These earn us nothing, so we have been searching for (and found) a different form through which to place a part of this money. Real returns (above inflation) should be 4%, which represents a good alternative for temporarily parking cash.

I wish you a nice spring, and I look forward to seeing you at the annual Shareholders Meeting.

Daniel Gladiš, April 2014

SIXTY-THREE

Dear shareholders

In the second quarter of 2014, the Fund's NAV diminished by 1.6%.
Since the start of the year, it has grown by a total of 5.5%.

100-fold? Really?

During April, I organised a series of lectures entitled Equity Investments at the Faculty of Economics and Administration of Masaryk University in co-operation with the Investors Club there. I enjoyed it immensely. It was so refreshing to observe smart young brains as yet unburdened by professional deformation spending their free time pursuing an interest in equities investing. In one of my lectures, I told them that their young age is their greatest investment advantage, as it is quite possible that over the course of their lifetimes they will experience a 100-fold growth in the equity market.

Does that seem like too much? Well, it did to me too at first glance. But let us look at some numbers. Let us say that the students' average age is around 21 years and their life expectancy is around 84. Looking back 63 years, at the end of 1950, the value of the S&P 500 stood at 20. Today, it is approximately 100 times higher. Could it not in 63 years be at a value 100 times greater than today's? All it takes is for the future to be similar to the past. That will not necessarily be the case, of course, but I think **it is more probable that the next 60 years will be similar to the past 60 years than that they will be radically different.** Of course, I am talking about returns on capital and not about geopolitical and social developments. **Returns on capital are much more stable over the long term than it might seem.**

Yes, the future is uncertain. And the more distant it is, the more uncertain it gets. But investing is not a natural science. Investing is always a matter of probabilities. It is not so crucial whether the markets increase by 50, 100 or 200 times over the next six decades. What is important is that it is highly probable that they will rise very significantly. In order to profit from this probability, we must fulfil the following four conditions:

1. We must invest. Anyone who does not invest has a probability of returns equal to zero.

2. We must start early. Every ten years of waiting decreases the final result by approximately one-half.

3. We must have sufficient discipline to withstand even occasional large market fluctuations and not to deviate from our course.

4. **The probability of large returns is practically zero if we hold cash, bonds or gold. We must buy equities!**

VLTAVA FUND

Okay, but 63 years?

I know that an argument built upon a 63-year investment horizon invites mockery, as for most so-called "investors" an investment horizon of even 63 days is too long. That 63 years is not, however, meant as a recommended investment horizon. It is rather a number corresponding approximately both to my students' life expectancy and to a nice round figure for gains that well illustrate the good sense of investing long term into equities.

In practice, it is not necessary to consider horizons longer than half a century. Many people try to make money with horizons of not only 63 days, but also 63 hours, 63 minutes or even 63 seconds. I am not saying that is not possible, but shortening the time horizon sharply decreases the probability of success. If we manage to think in terms of a horizon of at least 63 months, then the probability of good results is many times higher.

Capitalism is essentially based on the fact that capital – which bears risk – yields higher returns than do cash or bonds. If that were not so, then the world would be turned on its head. By investing into equities, we endeavour to profit from that.

What does Warren Buffett say to a long-term investor about asset allocation? In this year's letter to shareholders, Buffett states that after his death his wife will inherit his money. He issued the following instructions for investing it: **10% cash, 90%** equities. I think this says it all.

Buffett is a genius with fantastic results and greater experience than any other living investor, and, most importantly, if you read his letters to shareholders over the more than 60 years of his career, you will find that he is practically always right. So, if you do not agree with him, if you think he is mistaken this time, dear readers, then the burden of proof is on you!

(Confession: If we at the Fund had followed Buffett's advice more often over the past 10 years, our results would have been even better.)

Bob Dylan and Warren Buffett

When I use to play with a band and wrote our songs, I very soon found out that no matter what one writes one finds that Bob Dylan has already written something similar. It is as if you were sitting on a river bank trying to fish, while Bob was sitting a kilometre upstream and had already caught all the fish.

What Bob Dylan is to songwriters, so Warren Buffett is to investors. Any time I use an argument to support long-term investment in equities, I cannot avoid having the feeling that Buffett has already said something similar. If you feel like that as well, it is probably true.

Changes in the portfolio

In the past quarter, we sold one title and bought three new ones.

We sold **Microsoft**. When we had started buying Microsoft shares about 4 years ago at between $22 and $25, we were met with unexpectedly negative responses. Almost everyone slapped their foreheads in incomprehension. Why would we buy a company that almost everyone knows is gradually dying? This seemed like nonsense to us, and for some time we endeavoured to explain it (albeit in vain). After some time, we rather preferred to stop talking about owning Microsoft and instead to buy more shares. The market's general rejection of Microsoft seemed to us a good argument for purchasing its shares. Only unpopular assets can be truly cheap. Now we have sold the shares at about $40 apiece, yielding a return of about 70%.

We bought one financial institution in Japan, one US spin-off, and one US company that combines everything one could wish for – a unique business model, excellent historical results, enormous potential, great management and, especially, an attractive share price. It seems the market is blind once again.

While the first two purchases are more medium-term investments aiming to benefit from a momentary opportunity, the third case may well represent one of our key long-term positions.

Even in the sixth year of nearly uninterruptedly rising equity markets, it is still possible to find attractive investment opportunities. Most are outside the mainstream of investors' interest. We would like to thank "investors" with 63-hour investment horizons for creating such opportunities. ☺

I wish you a nice summer.
Daniel Gladiš, July 2014

FIRST TEN YEARS

Dear shareholders

In the third quarter of 2014, the Fund's NAV grew by 1.6%.
Since the start of the year, it has expanded by 7.2%.

First ten years

Last month, Vltava Fund entered the second decade of its existence. On the occasion of this anniversary, we took a little look back. I must say that the decade had been a fascinating one. We experienced enormous growth in markets, their spectacular crash, and a subsequent unexpectedly long and strong recovery. We had first row seats for it all as direct market participants. From a purely academic perspective, one would say it was an exceptionally fruitful period. Investors received one lesson after another.

Over this time, we succeeded in making many good investments, but we also made plenty of mistakes and it was our errors upon which we dwelt most during this retrospective self-examination. One's own mistakes are often the best source of lessons, and we would like to share the main ones with you.

We had begun excellently. From our foundation in 2004 until the end of 2007, we beat the global market by an approximate 2:1 margin. This means that our returns were approximately twice as great as those for the market as a whole. Looking back, it is clear that some of our results came at the expense of excessive risk. The high returns went to our heads a little, and we got the impression that we could do no wrong. We increasingly were led astray by excessive self-confidence, by haste, and by efforts to make money too quickly and beat the market by even greater margins. We began to be needlessly creative, absolutely underestimated the amount of risk, and, in certain investments, strayed far beyond our area of expertise.

In 2008, we met with a day of grim reckoning. While it is true that all investors were hit very hard in that year, our own bad results were due only in part to external influences. The other part was the consequence of our own mistakes. This came as a shock to us and to our investors at that time. All our missteps became plain to see, and we were dealt a harsh lesson in humility. Time cannot be turned back, however, so there was nothing to do but learn from those mistakes and move on. They must not be repeated, and perhaps they may even be turned to our advantage. Certain things perhaps need to be experienced first-hand in order finally to understand them.

At the start of 2009, we entirely changed our strategy. We realised that beauty lies not in attempts at complexity, but in simplicity. We perceive and define risk entirely differently, we are more patient, we are not in a hurry, and capital preservation is now more important to us than beating the market. The quality of the portfolio and of individual positions is our first priority. To our pleasant surprise, all these changes have had no negative effect on the Fund's results. From the start of 2009 until today, we are again beating the market by a 2:1 margin. Just what all this means cannot be known with certainty. Chance may be playing a large role, but, in any case, it is very encouraging.

Almost all our investments are now in developed markets. This fact stems from our considerable and far-too-frequent earlier negative experience with the level of corporate governance in emerging markets. We also are concentrated in fewer sectors, and predominantly in those sectors offering investors attractive characteristics over the long term. This is again the result of accumulated knowledge and a heightened focus on high quality and low risk.

None of this means that the value of our portfolio is immune to sharp decline. That can happen, of course, and sooner or later we can expect to see a considerable decrease. Such is almost unavoidable, and that is true of all equity portfolios, not just ours. We have every reason to believe, however, that when it comes the correction will be substantially much smaller than the drop in 2008 and it will be only temporary in nature. In an odd way, we are sort of looking forward to a larger market decline, as we believe the quality of our portfolio would stand out in such a state of affairs.

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Changes in the portfolio

We sold one title and bought one.

We sold Imperial Tobacco. Cigarette producers have long been in our wide-range viewfinder. Last autumn's purchase of Imperial Tobacco shares was part of our endeavour to understand the sector better. Even after a year of further effort, however, we unfortunately are unable to anticipate how the sector will develop overall. Although certain tobacco companies seem to be at acceptable share prices, that is not enough for us. In the end, we threw in the towel and sold the shares with an 18% gain. We prefer to move the money to someplace where it will be more predictable for us.

We bought one US company. It is one of the best-known global brands and an excellent company from all viewpoints. We would love to own the whole thing, but we are too small for that. Its business is cyclical, and it is currently in the third year of a declining phase. It seems to us that the market is short-sightedly undervaluing the fact that it represents a very attractive opportunity from a long-term perspective. We began building our position slowly because we know we cannot exactly pinpoint the bottom of the cycle.

Equity markets as a whole are not experiencing a bubble (bond markets are much closer to that), but neither are they bargain-priced overall. The US market is probably the most expensive of the large markets, while the UK and Japanese markets, for example, are priced very reasonably. In general, this would urge caution, and we are in fact trying to be careful. At the same time, however, there are still a number of very attractively priced titles out there, and many of these are very high-quality and well-established companies with relatively low risk (the most risky stocks on the market are at the same time the most expensive ones). So, we are a bit on the horns of a dilemma. On the one hand, we realise how expensive markets are overall, and, on the other hand, we still see good investment opportunities available. We are attempting to find the golden mean. We are carefully buying here and there while holding reasonable cash in reserve for potentially more-distressed times.

Daniel Gladiš, October 2014

INTEREST RATES, OIL AND THE ROUBLE

Dear shareholders

In the fourth quarter of 2014, the Fund's NAV grew by 10.5%. For 2014 as a whole, it rose by 18.5%.

Interest rates, oil and the rouble

As 2014 gives way to 2015, thoughts turn to what the new year has in store. We do not want to become overly preoccupied with such ruminations, however, as then we would need to admit that we have not the slightest idea what will come to pass, and this letter to shareholders would therefore be exceedingly short. We nevertheless can consider what 2014 brought us and how best to learn from it. Of all that happened in 2014, the most valuable lessons for investors came from developments in interest rates, the price of oil, and the rouble exchange rate. Although these involve different quantities, the lessons they provide are similar.

At the start of the year, the market was dominated by a general consensus on a future rise in interest rates and even as late as summer by consensus on the high price of oil. **Lesson 1: What appears obvious to most investors often turns out to have been mistaken.** Interest rates on all major markets moved downward and in a number of countries reached new lows not seen in several hundred years. If few people anticipated this decline, then absolutely no one expected that the price of oil would fall by nearly half over two months' time. The speed of oil's price drop was even more surprising than its extent. **Lesson 2: When a situation begins to**

change, most investors are surprised by how quickly that change occurs.

Continuing on the subject of oil, the worst aspect is that no one is able to say whether the price at USD 55 is inexpensive or whether it is still expensive. **Lesson 3: Assets that do not produce income do not have a fundamental value.** Oil, just like gold, is an asset that in contrast to equities, bonds and real estate produces no income, and it is therefore not possible even to approximate what is its "true" value. While for equities, it is possible to rely on a company's profits or assets and at least approximately to estimate their fundamental values, oil and gold lack such reference points.

Investor psychology plays a substantial yet unpredictable role in determining the prices of oil and gold. Investors can be both optimistic to the upside about an oil price of USD 100 and pessimistic to the downside when the price is at USD 55. **Lesson 4: Investor confidence is a very valuable but at the same time unpredictable thing.** Once investors lost confidence in the high price of oil, that price began to fall at an unexpectedly rapid pace. The same occurred in the case of the rouble exchange rate. Fundamental reasons alone cannot explain the halving of the rouble's exchange rate from summer to the end of autumn. In connection with investors' loss of confidence in Russia, the rouble's fall is entirely unprecedented. **Lesson 5: Although things may long appear to be going along just fine, as soon as the turning point comes, a situation often becomes completely hopeless.** History provides many examples confirming this lesson. Such a situation can occur in relation to various types of assets, individual companies, and even countries. This fact is forgotten in periods when everything appears to be working well. And it is just such good periods that can presage future problems. Russia lived for a long time off a feeling of self-satisfaction nurtured by the high price of oil. When that price fell, it became clear that the Russian economy is still vulnerable and overly focused in a single direction. By no means does Russia stand alone in so behaving. The governments of most western countries today live in the relative comfort provided by extremely low interest rates which mask the true size of their debt problems. Instead of taking advantage of those rates to solve those problems, the governments are succumbing to indifference and feelings of self-satisfaction. **Lesson 6: Cheap money is a source of self-satisfaction and in the end results in greater instability.**

If the price of money were not deformed by the central banks, economic growth might be more stable. Interest rates would be higher, investors and companies would require greater returns on investment, there would not be so much speculative behaviour, a number of investment projects (including in oil) would not have been implemented because they would not provide sufficient returns, and governments would be under greater pressure to put their finances in order and manage the economy. Moreover, the oil price might not have fallen by a half, as it would not have been so high to begin with, and, due to a lower price of oil, Russia might have progressed further in diversifying its economy. While these hypotheses can be neither proven nor refuted, in the real world within which we live, we can observe **Lesson 7: Unlikely events happen relatively frequently.**

We must be prepared not only for the fact that the frequency of exceptional events will be greater than is indicated by statistical models, but also for the fact that **(Lesson 8) new surprises will probably come from completely different directions than those we expect.** This is probably our sole prediction about the future. If ever you have the sense that you are prepared for possible risks, then you should always remember the words of Monty Python: "And Now for Something Completely Different". (And if it doesn't help, we still have their "Always Look on the Bright Side of Life".)

Implications for investing

If this were an academic essay, we could finish here. Our task is to invest real money, however, and so we must implement the eight lessons cited above into our investing. Specifically, we carry these into practice as follows:

1. We are aware that we have almost no ability at all to predict macroeconomic developments, and we do not even attempt to do so.

2. We avoid investments the success of which depends on any specific scenario for future development. Rather, we seek out such investments as will turn out well under the majority of possible future variants in that development.

3. In selecting investments, we consistently proceed on a "bottom-up" basis, founding our decisions on our views regarding fundamental value.

4. We give preference to such investments for which the distribution of possible development variants is relatively narrow. **We put more weight on probability of an outcome than we do on expected returns.**

If we look at the 10 largest positions in our portfolio, their earnings per share (or book value in the case of such companies as Berkshire Hathaway for which book value provides a better indicator of growth than do earnings) over the past 5 years grew by an average 66%. The least growth was 33% and the greatest was 117%. Growth of 66% over 5 years means annual growth of about 10.6%. Over the long term, this growth rate must roughly correspond with rising share prices. (When dividends are included, the investment returns are even higher.) We have not held all of these companies for 5 years, but we have held some of them for even longer. When we look at our portfolio again after the next 5 years, it is possible that we will still be holding the large positions which we have today, and we expect that their profits will again be seen to be higher. We cannot say whether this will be by 66%, 46% or 86%, but it is very likely it will be significantly higher. This should correspond with considerably higher share prices.

Our task is to select such companies for which the probability of positive development is high and then acquire shares in those companies when they are trading at attractive prices. **Our experience tells us that future development will not be linear. Rather, it will fluctuate, and occasionally painfully so. As long-term investors, however, we may ignore market fluctuations most of the time, and sometimes even use them to our advantage.**

Changes in the portfolio

In the past quarter, we conducted very few transactions. It was not necessary to change anything about the portfolio. We sold nothing and bought only one new position. After several years, we have returned to the German market. We acquired shares in a family-owned company comprising one of the large global brands, which is well-managed, debt-free, and with a pile of cash – all for less than seven times earnings. During their October drop, equity markets brought to us on a silver platter something that would have sold for at least twice as much in a private transaction. What a bargain!

We thank you for your continuing patronage and look forward to how we will experience 2015 together.

Daniel Gladiš, January 2015