VLTAVA FUND

RISK-FREE STOCKS

Dear shareholders
In the third quarter of 2015, the Fund's NAV decreased by 8.1%.

Our previous letter to shareholders evoked a great deal of reader response. We are having a small debate concerning the cause. I, of course, believe it was because the letter was a beautifully written investment classic. However, my colleague Jan Žák claims it was just because the letter's title included the word sex. To settle the matter, I have decided to title this letter entirely sexlessly "Risk-Free Stocks".

Properly defining risk

At first sight, the connection of "risk-free" and "stock" seems like an oxymoron. Most people even consider the word "stock" as almost synonymous with risk. In general, however, stocks are much less risky in comparison not only to the ideas in investors' heads but also to other asset classes. **Shares in certain companies can even be considered risk free by definition.**

Now, I will attempt to explain step by step how we reached this conclusion. Let us begin with a quote from Warren Buffett:

"We … [define] investing as the transfer to others of purchasing power now with the reasoned expectation of receiving more purchasing power – after taxes have been paid on nominal gains – in the future. **More succinctly, investing is forgoing consumption now in order to have the ability to consume more at a later date."**

This definition leads to several important conclusions. First, **the investor's greatest enemy and at the same time his or her motivation is inflation.** If over the long term inflation were zero, or even negative, we would not need to invest because money would not lose its value. Inflation is positive over the long term, however, and even at current low rates money will lose half its value over two generations. Even just a slightly higher annual rate of 2.5% would destroy three-quarters of that value.

Second, Buffett's definition clearly shows that investing is a long-term matter. The investor's objectives must also be long-term. **Investing is not about weeks or months but rather the next decade or two.**

Third, **what is main risk for the investor? It is that he or she fails to achieve his or her objective, which is to increase the real value of his or her money over the long term.**

The effort to achieve this objective can be blocked essentially by two things: selecting an investment asset class with a low probability of achieving the objective and permanent loss of capital, which could occur within the selected asset class. Therefore, if we accept Buffett's definition of investing and the objective which follows from it, **the greatest investment risk comes from poor choice of investment asset class and poor choice of individual investments within the selected asset class.**

This risk definition of ours is not customary, and it represents by far a minority view. We nevertheless regard it to be correct. Mainstream theory defines risk otherwise, namely as volatility. Simply said, the less an investment asset's price fluctuates the less risky it is. There undoubtedly exists a certain relationship between risk and returns. The more risk an investor takes, the greater the compensation in the form of returns he or she requires. This is entirely logical. The opposite relationship would make no sense. If we equate risk with volatility, however, this should mean that investors seek more volatility in order to obtain more profit. Have any of you ever met such an investor? I have not.

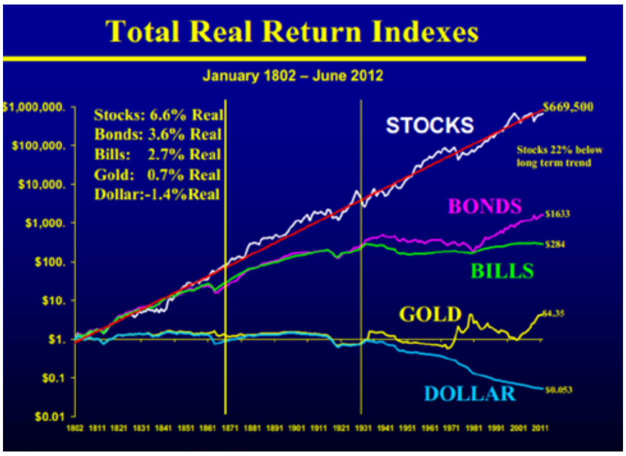
When risk is defined as price volatility, the assets considered the least risky will be those for which prices fluctuate the least – cash, bank deposits, treasury bills, short-term government bonds. The problem, however, is that in practice these assets prevent the investor from achieving his or her objective – to increase the real value of his or her money over the long term. **What good does investments' low volatility do an investor if they do not enable him or her to achieve his or her objective? Are such investments not rather too risky?**

Defining risk as volatility is wrong. It deforms investment considerations and leads investors to poor asset choices. **In the long term, volatility is practically irrelevant.** Over the past 30 years, shares in Buffett's Berkshire Hathaway recorded four big drops in the range of 37–51%. For many investors, this is unacceptable volatility which would prevent them from investing into this equity. For a long-term investor, however, it is an entirely usual phenomenon affecting even the highest-quality shares. Whoever bought Berkshire shares for $ 1,300 in 1985 and holds them today at a price of $ 200,000 is certainly not complaining about the temporary volatility they needed to wait out.

I am aware that the long-term returns on Berkshire shares are exceptionally high and that this is not typical for common equities. However, I want to use this example to demonstrate something else. Buffett is one of the best CEOs in history. He minimises the errors he makes, allocates capital in an exemplary fashion, and acts completely in shareholders' interest. However, all this cannot prevent the shares of the company he manages from undergoing considerable price fluctuation from time to time. That is simply how it goes. It is important truly to understand that this is not a source of risk.

Returns on individual asset classes

A glance at the following graph makes it clear that not only are stocks the asset with the highest returns over the long term, but they also have the least deviations from their long-term trend.



Source: Jeremy Siegel, Stocks for the Long Run

If we accept the initial assumptions that

1. the investor's objective is to increase the real value of his or her money over the long term,
2. the investment horizon is long,
3. volatility is not only not considered to be a source of risk but is essentially ignored (in the ideal case it can even be used to the investor's benefit), and
4. equities hold the greatest hope for positive real returns and so also the lowest risk of not achieving the investor's goal,

then it is evident that stocks must form the basis of every investment portfolio.

Risk-free stocks

Investing in equities does entail risk, of course. It is not risk of price fluctuations, however, but rather risk related to individual companies' operations. These risks can be divided into several categories:

- Technological
- Cyclical
- Regulatory
- Currency
- Financial
- Operational
- Managerial

Among the many companies whose shares are traded on the markets, some can be found which minimise such risks. We therefore consider their stocks to be risk free. First, they are in the class of assets the high returns of which over the long term minimise the risk that the investor will not achieve his or her goal. Second, they also minimise the second greatest risk, namely permanent loss of capital.
A portfolio comprised of stocks of such companies can be considered risk free. It will very probably produce positive real returns over the long term and with minimal risk of permanent loss of capital. As investors, of course, we need not limit ourselves when assembling a portfolio to only risk-free stocks. These provide only a starting point. Our task is to study individual companies, form an understanding of the amount of their business risk and possible investment returns, and then select the best combination of risk and returns. Most investors strive for an ideal combination of risk and returns, but the alpha and omega of such efforts is the correct definition of risk.

Imagine two identical companies. They are absolutely the same and differ only in the fact that the shares of one are traded on an exchange while those of the other are not. No one would be likely to assess the risk of the company not traded on an exchange according to its price volatility because its price is not available. Its risk would clearly be assessed according to the aforementioned categories related to the company's operations. Well, risk of the company traded on an exchange should be assessed in exactly the same manner. **The definition of risk cannot simply change based solely on whether stocks are traded on an exchange or not.** Trading on an exchange is only an additional advantage that enables us to respond to extreme market moods and potentially achieve higher returns.

Changes in the portfolio

Shares in **Precision Castparts** (PCP) are on their way out of the portfolio. PCP makes special metal products and components, in particular for the aviation and energy industries. We have been watching the company for several years, but it always seemed expensive to us. We were eventually rewarded in spring by seeing its price drop by about one-quarter from its previous high. We therefore began building our position. We were pleased when about one month later it became apparent that Buffett had also begun buying PCP in the first quarter. Given that neither equity markets as a whole nor PCP share prices in particular were rising, we gradually bought more and more PCP shares for increasingly better prices. It seemed there was no reason to rush. But one Sunday morning in August, we discovered that Buffett's Berkshire Hathaway was purchasing PCP as a whole. At that time, about 5% of our portfolio was in PCP and we had built approximately two-thirds of our intended position. Our feelings are therefore mixed. On the one hand, we are pleased that Buffett sees value where we see it, and of course we are pleased by the quick gain of about 17%. On the other hand, we like PCP a lot and we had assumed that over the long term it would become one of our main positions and would make us a great deal more money over time. We can find small comfort in the fact that we will continue to own PCP through our shares in Berkshire.

We bought two positions. One in Canada and one in the US. The Canadian company is one of our old acquaintances. We owned it during 2004–2006. We sold it then because we had reservations about the actions of the main shareholder of the time, the founder and director in a single individual. That person left several years ago, however, and we are quite partial to the current management. It is a big, global, and financially strong company, currently available for less than nine times earnings.

Our second new purchase is from the financial sector. We systematically endeavoured to find a relatively young company with an established and, in particular, expandable business model. We eventually succeeded in finding such a company, and we believe it will one day grow to many times its current size. We therefore expect many years of high growth, and at its current price we need not pay for that upfront.

We were relatively active this quarter, including in expanding several existing positions. Prices are falling, and after a long time we have more good investment opportunities than we can use. That is a very nice problem to have. The influx of new money into the fund and the sale of PCP have provided us cash enough for further purchases, and all we can do is wish for prices to become even more advantageous than they are already.

Daniel Gladiš, September 2015

P. S. I would like to thank my friend Alex Rauchenstein from Strategic Investment Advisors. During a recent breakfast, we discovered that our thinking about the concept of "risk-free stocks" is similar and Alex was a partial inspiration for my writing this letter. Alex and his colleagues are also the source of the division of business risk into individual categories.

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Our estimates and projections concerning the future can and probably will be incorrect. You should not rely upon them solely but use also your own best judgment in making your investment decisions.

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The shares in the fund can be offered to investors in the Czech Republic pursuant to Section 272 of Act No. 240/2013 Coll., on Management companies and investment funds.

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