VLTAVA FUND

WHAT IS REALLY NORMAL?

Dear shareholders
In the first quarter of 2015, the Fund's NAV declined by 0.6 %.

Are negative rates normal?

It frequently happens that people consider current events to be exceptional, but it usually becomes clear in hindsight that nothing that was happening was truly extraordinary relative to history. This occurs because people tend to ascribe greater importance to present developments than they are due. At the risk of making the same mistake, I nevertheless maintain that in certain respects the current situation on financial markets has no historical parallel and is entirely exceptional.

The world's main central banks have never before dared to carry out such enormous experimentation. By their combined efforts, they have pushed interest rates to an historic super low in not only nominal but also real terms. Interest from commercial banks' deposits at central banks is in some cases negative (e.g. at the ECB, in Switzerland and Denmark) and practically zero in others (e.g. in the U.S. and Japan). Yields to maturity on government bonds from a number of Western countries hover around lows not seen in several hundred years (e.g. Germany, France and the Netherlands) and in some cases are even negative (Switzerland and Germany). Finland even recently issued five-year bonds with negative yields.

Why are central banks doing this? Their logic is driven by efforts to force consumers to save less and spend more, induce banks to replace low-yield bonds with loans to businesses, reduce businesses' and governments' costs for servicing debt, and induce investors to invest into riskier assets (thereby driving up those assets' prices and achieving wealth effects which should result in greater confidence in the economy and greater consumption).

Central bankers are only flesh and blood, however, and they make the same cognitive errors as do the rest of us. One such mistake might be their present herd-like behaviour. As I follow them in the media, one thing stands out to me. It seems to me they have absolutely no doubt as to the correctness of their actions. That makes me very nervous. They copy one another's behaviour, and the fact that they all act in the same way gives them a false sense of security. The history of financial markets has seen many instances, however, when what most people considered to be correct was eventually proven to be a mistake.

What does current evidence say?

A look at the real economy does not suggest, however, that the result is very favourable. Household consumption is weak. Might this not be caused by negative real rates forcing people to save even more? Companies are not investing much. Might this not be caused by their being restrained by consumers' cautious behaviour as well as extraordinarily low returns to capital? Banks have excess cash, but loan volumes continue to grow only very slowly. Might this not be caused by the fact that companies are investing rather little? After seven years of "saving", governments have more debt than ever before and have implemented practically no long-term structural reforms. Might this not be caused by their being lulled by cheaply accessible cash and low borrowing costs?

The sole thing the central banks have managed to accomplish is to drive up asset prices. This distorts the overall impression of their policies. Wealth effects act like a narcotic and make other problems seem less urgent. How would we evaluate the overall situation if equity markets were lower by, say, one-third?

Deformed capitalism

If there is one variable in economics that can be called key, it is the price of money. However, central banks have deformed this value so much that it cannot fulfil its role at all. It deforms market relationships and returns to capital. For capitalism to work, the price of money must be reasonable. Today, it certainly is not. **Two-thirds of government bonds issued by western countries today provide negative real returns. Central banks in countries operating on capitalist principles have decided that real returns to capital will be negative.**

How should such an economy work correctly? The deformation affects not only the price of money, but also people's thinking. I believe that at some point in future when we look back at today, we will find it unbelievable that many bonds were trading with negative real yields. Nevertheless, most investors today see it as normal. If that were not the case, bond prices would be lower. When something clearly insane is considered normal, then perhaps the entire contemporary society has gone mad.

Implications for investing

Investors today have lost their perspective and regard the current state as normal. Few people today fear a substantial rise in interest rates. Most investors rather tend to extrapolate the present state into the future, and this is very dangerous. A great source of risk can be found in investors' very impression that risk is low.

Future yields on all asset classes have adjusted to low interest rates. In other words, they have decreased. Today's prices on bond and equity markets (and, of course, prices of real estate, land, art, gold and other assets) can be justified only against the backdrop of abnormally low interest rates. If these rates would begin to rise, the prices of all assets will come under pressure.

The future is always uncertain, and matters will obviously develop in ways other than we expect. We are aware of this fact, and we therefore endeavour not to gamble with our investments on any particular future development scenario – neither that rates will rise nor that they will remain low. We endeavour to invest so that we will be successful in either case.

We have almost nothing to say about the direction of markets (which in no way differentiates us from other investors), and it would be naïve of us to try. We can, however, choose whether our portfolio will be aggressive or defensive. At present, our considerations unequivocally lead us to a defensive stance. This means being very selective in choosing equities and not being afraid to hold more cash if we cannot find sufficient investment opportunities.

Equity markets have recently been relatively calm. Volatility is low, but it would probably be a mistake to regard the markets today as stable. Volatility and stability are two different things. Equity valuations that have Shiller's cyclically adjusted P/E approaching two standard deviations above its long--term average, absurd bond prices, and significant recent movements in certain currencies – these all are elements of instability which must be recognised. It is therefore no coincidence that the proportion of cash in our portfolio is the highest it has been for the past 7 years.

Changes in the portfolio

We sold three titles: Catlin, Asian Citrus and Humana. Coincidentally, all three are among our oldest investments. We held them for 6–8 years. We had a different reason for selling each one.

Catlin is an insurance company we began buying in 2008. It was one of our favourite positions. Stephen Catlin, who founded and still manages it, has built an excellent company. We would have been happy to hold it for maybe another ten years. In January, however, Catlin was bought by XL Group. In the newly merged company, XL Group will hold the majority, its management and culture will dominate, and no one knows how long people from Catlin, including Stephen Catlin, will remain there. We are not interested in the merged company's shares, and we have therefore sold Catlin. We are definitely not complaining, though, as we have more than tripled our money. Our overall return was 211%.

We first bought **Asian Citrus** in 2007 and gradually built our position over the following two years. From our average purchase price of approximately GBPp 20, the share price grew to GBPp 80 in 2010 and the company appeared to have a great future ahead of it. At that time, however, the company began a long--term decline. Almost every misfortune possibly imaginable in fact occurred: typhoon, torrential rains, disease, an overpriced acquisition, megalomaniacal expansion and, most especially, poor corporate governance and management's poor relations with shareholders. We spoke with management many times, met them in person, wrote letters to the board of directors, joined with other dissatisfied shareholders in votes at the general meeting, but it led nowhere. Asian Citrus was a stock for which just as in Jára Cimrman's operetta Proso (Millet) instants of high expectations alternated with instants of disappointment. We gradually began reducing our investment and have finally completed its sale. In hindsight, we should have sold it long ago. It is only because we sold some of the shares close to their peak five years ago that we earned any money overall. Our annualised return was nevertheless negligible.

Humana is a health insurance company we bought at a low, post-crisis price in 2009 for less than five times earnings. Prices were so low then! Now, we have sold it for approximately 20 times earnings and at a price almost five times higher than what we bought it for. The price simply appeared to us to be too high. Our return was 380%.

We did not buy any new positions, but only on several occasions added to positions we were already holding. The most recent such occasion, as it happens, was this morning before I began writing this letter.

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

Daniel Gladiš, April 2015