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 55 USD 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 100 USD and pessimistic to the downside when the price is at 55 USD. **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