VLTAVA FUND

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!**

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.

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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
