VLTAVA FUND

GODZILLA (ゴジラ)

Dear shareholders,

In the second quarter of 2013, the fund's NAV grew by 1.37%.

Land of the Rising Sun (and dark storm clouds)

Let's take a trip to Japan. Why precisely there? Well, that will become clear in a moment. To many people, Japan may seem distant and irrelevant from an investment perspective. However, just the opposite is true. Japan is a big economy with expansive financial markets and is home to one of the main reserve currencies. It is contending with immense financial problems, and its efforts to resolve these will impact the entire world.

Here is a brief summary of the state of Japanese finances: Debt-to-GDP is 240%, which is twice that of Greece, Italy and Spain and five times the Czech Republic's debt. The annual budget deficit is 10% of GDP – three times larger than the Czech deficit. Budget outlays are twice as high as revenues, so the Japanese must borrow one yen out of every two yen of spending. In comparison with Japan, the entire western world looks like a shining example of commendable responsibility.

Even with the extremely low Japanese bond rates that now range around 0.85% per annum for 10-year securities, interest expenditures gobble up one-quarter of state budget revenues. Should interest rates rise to around 3%, interest costs would consume all budget revenues. There is not much to envy in the Japanese situation.

The Japanese need to cut the budget deficit without plunging more deeply into recession while also stabilising and progressively decreasing the overall debt and maintaining very low interest rates. I don't know if such a thing is possible. Probably not. Theoretically, however, there are two courses from which to choose.

The first is rapid economic growth. I do not perceive this as very probable. If we are to search for a period of surging growth in the Japanese economy, we need to go back more than 20 years. Over the long term, Japan has been slowed by its large debt, much inefficiency in the corporate sphere and tax system, as well as its own demographics.

In Japan, women give birth to an average of 1.5 children. To maintain the current population size, a ratio of approximately 2.1 is needed. Japan last had such a fertility rate about 40 years ago. To put these numbers into perspective, **with its current fertility rate, each generation is 30% smaller than the previous one**. While in recent years Japanese GDP per capita has been growing faster than in the United States, the economy as a whole is growing much more slowly due to differences in demographic development. While the number of Americans is on the rise, the Japanese are diminishing in number.

It is not very probable that real economic growth will resolve Japanese debt problems. The Japanese economy is unable to grow even when it has a 10% budget deficit. If real growth is not an option, then there is still nominal growth, which is to say via inflation. A marked devaluation of the currency offers the easiest path. This will have a pro-inflation effect, and, in Japan's export-focused economy, even a pro-growth effect. At the same time, Japan needs to maintain its low bond yields.

Having thusly defined the problem, the Japanese have initiated massive so-called "quantitative easing" (i.e. printing money). The Bank of Japan began buying state bonds en masse with the newly created money. The market was flooded with yen, which led to its significant loss in value vis-à-vis other currencies while succeeding to maintain low interest rates.

The Japanese unleashed this operation on a breath-taking scale. Relative to the size of their economy, they are buying three times as fast as does the U.S. Federal Reserve. If there is any speed that can be considered crazy, this is it. And because Japan is a part – in fact a relatively large part – of the global markets, its new gigantic money-printing machine has rocked the whole world. **Japan's problem is also our problem.**

Godzilla's roar

The Japanese have awoken Godzilla, and its roar can be heard around the globe. See for yourself. Since November, when the Japanese took up their task in earnest, the yen has weakened sharply. The Japanese stock market spiked up by 75% and then had a 20% correction. Shares on the emerging markets have had their worst year in a long time, and the same can be said of their currencies. Bonds have been markedly dropping wherever one looks, and overall market volatility has risen substantially. Gold fell by almost a third, and in spring it took of its deepest one-day price dives of all time.

Imagine the entire financial world as a balloon being pumped with air – that air being newly printed money. When its flow and pressure get too strong, the balloon starts to leak at the weakest spots. Those are where large price fluctuations occur. The Japanese have already shaken the unstable global financial system and caused huge waves. **Great fluctuations in exchange rates and interest rates are primary reasons for big changes in global asset re-allocations, to which we are now witnesses.**

Changes in our portfolio

Based on the previous paragraphs, it might appear paradoxical that the past quarter was the first in the fund's history in which we did not buy any new positions or sell out of any. In considering any new investment, we always compare it with what we already have in our portfolio, and also with the option of doing nothing. During the past three months, we mostly found it better not to do anything. We were satisfied with all of our positions, with their gains and the development of their businesses. In June, when share prices started to fluctuate more in response to the Fed's unexpected rhetoric and the Chinese credit crisis, we became a bit more active and made some additions to our existing positions.

We do not suffer from rhinophobia, which is a fear of cash and the urge quickly to do something with it. We know that good opportunities always will come along. We have enough cash, and if they come tomorrow, we are ready. If not, we will patiently wait for those opportunities.

A lesson from Japanese development

What's happening in Japan is really big. No one, including the Japanese themselves, has a clue as to how it will all turn out. We are navigating unexplored waters without the possibility even to rely on historical precedent. One thing does seem obvious, however. In the absence of greater economic growth, the preferred solutions to financial problems will be to print money, devalue currencies, maintain negative real interest rates, and erase debts through inflation. Eventually, all states having their own currencies will go down this path.

What does it mean for investments?

1. Cash: This is useful as a reserve asset, but it will continue significantly to lose value over the long term.

2. Bonds: Their yields in no case provide any real compensation for the risks of inflation and default. They effectively represent almost certain loss.

3. Gold: Warren Buffett says it is good for almost nothing and does not multiply. Its historical yields are zero in real terms.

4. Productive assets (equity shares in companies): In a recent interview with a CNBC journalist, Warren Buffett recently said that equities are priced appropriately, "but you'll see numbers a lot higher than this in your lifetime."

This cannot be said about any asset classes other than equity. Therefore, shares should occupy the fundamental place in most investors' considerations and in their portfolios.

Wishing you a nice summer,
Daniel Gladiš, July 2013

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The shares of the fund have not been and will not be registered under the United States Securities Act of 1933, as amended (the "1933 Act") or under any state securities law. The fund is not a registered investment company under the United States Investment Company Act of 1940 (the "1940 Act").

The shares in the fund shall not be offered to investors in the Czech Republic on the basis of a public offer (veřejná nabídka) as defined in Section 34 (1) of Act No. 256/2004 Coll., on Capital Market Undertakings.

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