



Dear Shareholders,

we had another good year in 2010. Vltava Fund's NAV rose by 21.5%. That is a very good result both in absolute terms and relative to the markets. The main equity markets moved as follows last year: World +7.8%, USA +12.7%, Europe +7.3%, Japan -1.2%, and China -14.3%. Our performance was therefore much better than that of the world equity markets. It was also a lot better than our long-term goal of averaging 10% p.a. NAV growth, and it was superior to our return expectation at the beginning of 2010. In thinking about return, we should not forget that we live in an environment of (still) low inflation. Inflation in the Czech Republic was roughly 2% last year, thus making our real return nearly 20%.

The year 2010 was a rather eventful one, and it was dominated by several macroeconomic themes. Europe has drawn to itself the main spotlight, which is focused squarely upon its fiscal and sovereign debt difficulties. With their similar problems, the US, UK, Japan and increasingly China are by no means escaping that glare either. The latter country continues to struggle with an undertaking – central planning in a state-owned economy – which has defeated all those who have attempted it.

Macroeconomic developments will likely play a major role in 2011 and also in the coming years. We perceive four main issues. First, a lot depends on actions taken by governments. It will be important what they do and whether they get it right. Unfortunately, the role of governments will be larger than in the previous two decades. Many governments got their countries into deep troubles by being too active and spending too much. Now their goal

is to become even more involved and to gather more power and influence in order to solve the problems that they themselves created.

Governments in the western world are moving more towards socialism in order to stay in power, and the bureaucrats in Brussels perhaps best exemplify that. Governments in the eastern world will need to introduce a little capitalism for the same reason – to stay in power. China is the best example. That makes the whole world a bit messy and uncertain. Our goal is to find companies least affected by governments actions.

Second, most governments have to start to reduce their spending and vastly improve their budget balances. The persistent and growing budget deficits of the last decade or two are not sustainable. And if something is not sustainable, then by definition it has to change. If things would not change in a reasonable manner, then sooner or later all tax revenues would be consumed by interest payments for the government debt.

Many countries will need not only to bring their budget deficits down, but they will have to work towards balanced budgets – and in some cases even towards surplus budgets – in order to lower their total indebtedness. These outcomes are both inevitable and long-term in nature. They will have major impacts on the corporate world and its profitability. If you view the economy as a closed system, then lower cash outflow on one side (the



government's side), must be balanced by lower cash inflows on the other side (the side of consumers and corporations). And because many consumers are also heavily indebted, the main burden will be carried by corporations. They will simply be less profitable. Our goal is to find those least affected. (With a little luck, a large share of the decrease in earnings will fall to banks.)

Third, while it is generally understood that budget deficits must be cut and debt ratios reduced, this is no easy matter. There are several ways for countries to extract themselves from a debt crisis. Ideally, the economy would simply grow its way out of its difficulties. The debts in many countries are now so large, however, that the growth solution is simply beyond reach. Then, too, salvation might ensue from extremely low interest rates for a very long time. But those kinds of miracles do not occur. We already live in an environment of extremely low rates, by the way, and it is not enough.

It might be possible, at least theoretically, to solve the debt problem if someone else repays the debt. Well, if Greece were the only country in troubles, that might be the solution, but, since Greece is just one of many, this will not do. What else remains? Severely cutting expenditure to bring budgets into balance, perhaps? A nice idea, but politicians being politicians means that this is highly unlikely. That leaves two final options: default and printing money. These are the most probable. Some countries will default, and most countries will be printing money. While defaults will penalise mostly those holding the defaulted debts, printing money will punish everyone. Printing money is a dirty word among central bankers and governments, so

they use the more gentlemanly euphemism "quantitative easing", or just "QE". QE has been in full bloom for more than 2 years. QE essentially means that debts will be repaid with money that is worth less than the money that was borrowed. It is also commonly known as inflation.

During the summer of 2010, the markets were not doing very well and fear of a double-dip recession was in the air. Then, at the end of August, the Federal Reserve, which is the US central bank, announced additional purchases of government bonds - a new round of QE. From that time until the end of the year, US stocks soared by 19%. Other prices also went up a lot: oil by 16%, copper by 32%, corn by 43%, and cotton by 57%. Inflation ante portas!

Our goal is to find those companies that will benefit from higher inflation. Those will be companies that are able to pass cost increases on to consumers, companies that have so-called pricing power, and companies that operate with large proportions of fixed rather than variable costs. We have several such companies in our portfolio already.

Fourth, the fate of the euro and euro zone is another important matter. We can envisage several possible outcomes: (i) some countries leaving the euro and reintroducing their own currencies, (ii) managed default by some countries, or (iii) steady march towards political and fiscal union at the expense of huge costs, large transfers, loss of sovereignty and slow economic growth. All of these outcomes remain open possibilities for now. Our goal is to watch developments closely and find companies that will be least affected.

You may be wondering by now whether we have changed our investment philosophy. We



have always said that we are bottom-up stock pickers and now we are talking mainly about macroeconomic issues. There is no need to worry; we have not changed. We remain bottom-up stock pickers. The quality of individual companies, their potential and especially their valuations are still the main criteria for us. But we do recognise that the economic environment has changed, and it would be foolish not to take that into account. As always, and despite all the economic mess, there will be some companies that will thrive and prosper. Our goal is to find the best of them.

The present economic environment actually presents a good background for our investments. Why? Simply put, because it is uncertain. Uncertainty brings volatility and volatility brings opportunities. Warren Buffett likes to say that you pay a high price for a cheery consensus. This is very true. Now, we certainly face nothing today like a cheery consensus. Rather, we live in a world whose distribution of outcomes is flatter and with fatter tails. We love that! When we look at the past year, our best investments were made in May and in August – both periods of market fear. If there is something we can predict with

high probability, it is that periods like that will reappear from time to time, bringing with them excellent investment opportunities. We will be prepared and ready to buy at just such times and make the most of other people's panic.

Looking at the world today and considering its outlook several years down the road, we think that holding cash is a terrible option since the value of most currencies will go down in absolute terms. Holding bonds, that is to say lending money to other people, can be rather dangerous and, if combined with the risk of potentially growing inflation, it should probably be avoided. Holding high-quality stocks acquired at reasonable prices seems the best choice to us. That is what we have in our fund now. While we have no way of predicting what will happen to their prices in the coming weeks or months, we think the probabilities are very high that in several years time their prices will be a lot higher than they are today, thus making you richer in this uncertain world.

Daniel Gladiš, February 2011

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