VLTAVA FUND

QE 4EVER

Dear shareholders,

In the third quarter of 2012, the fund's NAV grew by 5.2%.

In slight contrast with the trend of recent years, markets were unusually calm this summer. This was not such a bad thing. At least we could better enjoy the holiday season's two highlights: the Olympic Games and Bruce Springsteen's concert in Prague. I saw Bruce for about the seventh time, each seemingly better than the last. In Prague, he played for over 3 hours without a break, even though the organisers turned up all the lights at the stadium an hour before the end to indicate that time was up. A few days later, during a concert in Hyde Park, the police even turned off the microphones. In the land that gave the world the Beatles! This did not unsettle Bruce, however, and just after that he played for over 4 hours in Helsinki. It's a shame that people like Bruce are not candidates in presidential elections…

Central banks back on the offensive

Unfortunately, slightly different sorts of people are found in politics, and just after they returned from their vacations they clearly indicated that they intend to continue to interfere with the course of history. The European Central Bank (ECB) was the first to make itself heard. It declared that the euro is irrevocable and that it will do "whatever will be necessary" to maintain it. Such proclamations can send shivers down one's spine.

The ECB also announced that it will purchase the bonds of euro zone states that are under pressure, should they themselves request international assistance. Such aid is conditioned upon strict demands with which the applicant country must comply. Of course, no one wants to do this voluntarily. Spain, for example, to which this applies first and foremost, will almost certainly request help. It will probably wait until the last possible moment, when the situation becomes entirely untenable. It will then ask for assistance, receive a list of conditions, and, if it undertakes to fulfil them, ECB will buy its bonds.

An interesting situation may occur sometime later, when ECB has its books full of Spanish bonds and the country ceases to fulfil the conditions of aid. What will ECB do then? Will it stop buying Spanish bonds? the local market would collapse. Or will it keep buying them and disavow its own declared conditions for the purchases?

Moreover, ECB undertook to "sterilise" the purchases of Spanish bonds in order to appease Germany. In practice, this means that it will sell other bonds – most likely German – in the same amount in order not actually to print new money. ECB's bond portfolio would thus shift from the highest-quality German bonds to the most problematic Spanish ones. I dare say, they will be the only ones in the world to be making such a reallocation.

An even more aggressive Fed

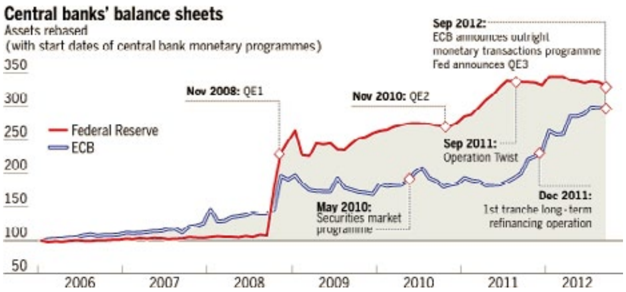
The U.S. Federal Reserve got into the act a week after the ECB. It announced another wave of quantitative easing (or "QE3", a euphemism for once again printing money) for an indefinite time (yet another proclamation to give one the chills). It essentially initiated interminable QE – QE 4EVER.

The Fed's step caught many by surprise. The U.S. economy will grow by almost 2% this year, and in the following 2 years (according to the Fed's own estimates) by around 3%. Interest rates are at record low levels, and that includes mortgage rates. The housing market is slowly recovering, and the stock markets are not far from their all-time highs. Based on this data, the exigency for another wave of QE somehow escapes me. It is true that unemployment is holding stubbornly above 8%, but that will not be diminished by printing money.

The main problem lies elsewhere: in the state's large role in the economy, in excessive regulation of business and the labour market, and in the uncertainty that politicians create through their actions. In response, companies invest meagrely and consumers spend little. But try telling something like that, for example, to President of the European Commission José Manuel Barroso. His calls for a European federation, a common army and, above all, federative taxes sound as if they are coming from another world.

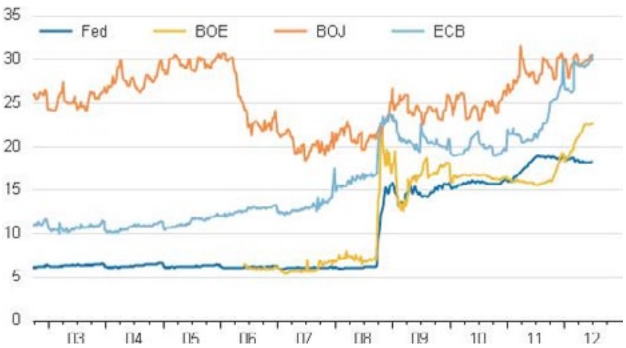
In 1985, Bruce had a huge hit “Born in the U.S.A.” Who will come out with the hit “Born in the E.U.”?

Graph: Development of central bank assets in the USA and euro zone (rebased, 2006 = 100%)



Source: Thomson Reuters Datastream

Graph: Development of central bank assets as % of nominal GDP



Source: Thomson Reuters Datastream

Changes in our portfolio

We sold 4 titles during Q3.

Seagate Technology. Seagate produces hard drives. This industry recently underwent an interesting development. Originally, there were 5 companies dividing the market amongst themselves. They frequently tried to compete on prices, which, as a result, damaged all of them in the end. The two largest, Seagate and Western Digital, then bought two of their competitors and suddenly controlled 90% of the market, thus gaining greater control over prices. Then came floods in Thailand, substantially disrupting the supply of hard drives to the market and considerably driving up prices. Seagate’s profitability markedly increased, but its share price did not reflect this. We bought Seagate during the spring slump in stock markets and sold the shares after about 2 months with a gain of 56%. We were aware of the cyclicality of this industry, as well as of the fact that, in this case, estimating share values is rather difficult. We were happy to take a profit.

Johnson & Johnson. We knew we were buying high quality when we bought shares of JNJ. Our expectations regarding future development, however, were not fulfilled. The company was treading water, was searching for a new direction, and, moreover, we were not satisfied with the way JNJ allocates its capital. We therefore sold the shares with a total gain of 13%.

BP. We considered long and hard to buy BP shares back in 2010, when major news media were carrying images of oil gushing into the bottom of the sea from BP’s Macondo well. Such screaming negative publicity often slashes share prices to unrealistically low levels. BP’s stock was no exception. Nevertheless, it seemed to us that the risks were too great and that it would be better not to buy. We did so a year later, however, at an only slightly higher price and with much lower risks. We held them for a year, but negative impressions gradually started to prevail. BP’s business itself lagged behind expectations, damage compensation claims for Macondo are still unresolved, and great disputes with the second shareholder in their Russian JV continue. So we decided to close that chapter and sold the shares with a total gain of 10%.

Halfords. We were not playing a lucky hand with the British Halfords. Our conclusion regarding the quality of the company and its outlook had probably been incorrect. We might just as well acknowledge our mistake. We sold the shares at a loss of 29%. Fortunately, it was one of our smallest positions, and so the damage is minimal. Incidentally, Halfords is the only stock bought in the last 2 years that is in loss territory.

On the short side of the portfolio, we closed our position in Chipotle Mexican Grill with a gain of 24%.

We also acquired two new positions. The bosses of the two companies are legends, are absolute aces in their fields. Their businesses have low correlations with the business cycle, and we expect double-digit annual returns from both titles. Investors spend half of their time debating whether Apple shares will reach a market cap of a trillion dollars while allowing a number of high-quality and much more attractive shares to go unnoticed.

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Macro vs. Micro

There is nothing rosy about the world's macroeconomic outlook. We can look forward to an extended period of slower growth, never-ending struggle with debt, occasional periods of escalation in the case of Greece's leaving the euro zone, the American fiscal cliff, and more.

One should recognise, however, that stock market growth is neither conditioned upon, nor correlated with, rapid economic growth. For example, the U.S. stock market remained unchanged between 1964 and 1981. During that period, GDP grew by 373%. In contrast, between 1981 and 1998, the American stock market increased tenfold and GDP only grew by 177%. The Chinese economy is one of world's fastest growing economies today, while the Chinese stock market has been among those declining most in the last 3 years.

We are not macro investors, and we do not try to invest according to estimates of macroeconomic development. Nevertheless, we of course are not blind to those developments. The conclusions we draw from them rather concern the long-term impact on individual asset classes. We believe that **if a state puts its mind to devaluing its currency** (reflect upon the Fed's recent action), **it will usually succeed**. This means that long-term bonds (which we refer to as "certificates of confiscation") can be held only by investors with an especially developed sense for financial masochism. Their extremely low yields fall far short of offsetting the associated risks for their prices to decrease. Shorter-term bonds yield so little that a number of money market funds are getting out of that business altogether. Cash yields nothing. All manner of debt instruments and deposits yield negative real returns and bear great risk of substantial real losses. And I haven't even mentioned the fact that states have every motivation to falsify downward their data on inflation. Real inflation may in fact be markedly higher than that officially stated.

The impact on share prices of printing money should be neutral in real terms and nominally positive over the long term. We therefore think that a considerable portion of savings should be invested into stocks.

We consider ourselves to be micro investors.
This means that we are not buying stock markets as a whole, but, rather, seek individual companies that will do well under almost any conditions and whose shares are, at the same time, low-priced. There are not many of those, but they can be found. We are approaching the end of the year with a part of the portfolio in cash, and the next time the market stumbles it will surely bring us attractive opportunities. With a certain measure of cynical materialism, we are looking forward to it!

Daniel Gladiš, October 2012
