VLTAVA FUND

IS A BREAK POINT CLOSE AT HAND?

Dear shareholders,

In the second quarter of 2012, the fund's NAV fell by 11.39%.

The last week of April and month of May marked the worst period for our fund since 2008. Prices for the majority of our shares fell sharply, albeit in no way relating to a change in their underlying values. At the end of May, our portfolio had its most attractive valuation in the fund's entire history. The combination of quality, low cost and overall market risk was then more favourable even than at the beginning of 2009.

The majority of our companies are currently achieving historic, record-breaking profits and have record dividends. On the other hand, their prices are mostly deeply below their highs. Even despite the fund's high returns in June, our portfolio remains priced at a very low level and it is therefore also relatively safe.

Why do we invest at all?

At the April meeting of the fund's shareholders, we started our presentation with just this question. Sometimes it doesn't hurt to return to first principles as they relate to one's rationale and actions.

Every person who has money exceeding that required for his or her present consumption faces this fundamental question: To invest or not to invest? As long as one does not invest and allows money to lie idle, with each passing day its value becomes less and less. That is due to inflation, and even our current moderate annual inflation rate of around 3.5% will erase 19% from money's value in 5 years' time. After 10 years, this decline would come to fully 41%.

It would be irrational to devote one's energies to earning money and then allow it to lay idle and watch as it gradually sheds value. It is certainly better to make an effort so that the value of money will be at least preserved, or even to grow. In other words – to invest. If inflation were zero, or even negative, we would not need to invest. The value of money would not decrease and in future it would be possible to purchase using it the same amount of goods and services – or even more – as today. Unfortunately, however, inflation is persistently positive. Thus **inflation is both the investor's greatest enemy and, at the same, greatest incentive!**

Our investment philosophy

While investing can be conducted in a million ways, it is possible to summarise our investment philosophy in five points:

1. **Stocks make the best long-term investment**
   The approximate real returns on individual asset categories over the course of the past 200 years are as follow: the dollar lost 95% of its value, while gold increased in value by 6 times, bonds by 1,000 times and stocks by 600,000 times. These figures refer to the American market, because it offers the longest and highest-quality data set. Nevertheless, it holds true generally that in the long term it is worst to hold cash and best to hold stocks

2. **The basis of investing into stocks is regular cash flow in the direction from companies to their shareholders in the forms of dividends and repurchase of their own shares.**
This relationship is often forgotten. More often than not, people do not realise that buying stocks is first and foremost acquiring a share in an enterprise's business. They often view stocks merely as an abstract object of speculation. At the same time, the reason why we buy them is no different than for why we buy bonds (to receive coupon payments), real estate (to obtain rent) or we use bank deposits (to collect interest income). Particular investments are valued according to their individual cash flow streams. Real estate that during its lifetime never brings in a single cent of rent has zero value, and the same is true for a company that during its lifetime pays no dividends. This is true by definition. Conversely, the higher the associated cash flows the more valuable is the given investment.

3. **At good companies run by quality managements, cash flows have a strong tendency to grow.**
   This fact can be confirmed through numerous examples. At the same time, it is abundantly clear that not every company falls into this category. At many

companies, cash flow either fluctuates excessively, decreases, or even vanishes for good. And that's where lies half of our work, as we look for companies whose cash flows grow in the long term and whose management works in the interests of shareholders.

4. **In the long term, share prices follow growth in cash flows.**
   This is a verifiable rule (although by no means a natural law), which has the tendency to reinforce itself over the long term. The second half of our work thus lies in endeavouring to forecast what value should be placed on the expected future cash flows of selected companies and then in buying those shares which trade at prices significantly lower than their estimated values.

5. **Many people think of the stock market as a casino and stocks as poker chips, thanks to which we can often buy shares at prices significantly lower than their intrinsic values.**
   Theoretically speaking, in an efficient market, the prices of shares would always reflect (at least approximately) their actual values. **People, however, are not flawless machines without emotions.** They make mistakes in their judgments and, moreover, they become overwhelmed by fear interspersed with greed. That's lucky for us. Were it not that way, it would be far more difficult for us to seek out good investment opportunities. But people are people, and so they will always remain. For that reason, the market will continue to be inefficient and will carry on in generating extraordinary investment opportunities. If we will succeed in taming our emotions and if we will maintain our investment discipline, we can profit greatly.

Short side of the portfolio

The foundation of our strategy is comprised of the portfolio's long side and a relatively concentrated set of shares chosen according to the aforementioned principles. In addition, we have in the fund a much smaller short side. In it we have:

1. A broad market index or indices serving for hedging purposes, and, as the case may be, as a low-cost source of capital.
2. Positions in individual companies whose shares are substantially overpriced and in relation to which we anticipate earning returns from their future decline in price.
3. On top of that, we use selective options either as sources of cash flow or as tools to increase economic exposure to individual companies while excluding possible losses.

The short side of the portfolio and options are complements to our long side, and they bring to the fund additional value and yield.

As I now read what I have just written, I am aware that our investment philosophy is in principle very simple. I candidly admit that it was not always so simple. When we started eight years ago, we looked at investment similarly as we do today, but we often complicated things unnecessarily. We were younger and more ambitious and we sometimes had the tendency to look for additional value in the twisting and turning tributaries of value. Time has taught us that is exactly where the greatest mistakes are made and that it is better to keep a steady course in the main channel of our investment philosophy. Today, it seems to us that the simpler the view we take of things, the better. I am curious myself as to how our investing will develop in the years to come. The beauty of investment is that experiences do not cease to accumulate, and one can constantly improve. At the same time, it holds true that one does well not to skip over or shorten the knowledge accumulation stage.

„Investing is simple, but not easy."

Warren Buffett

Changes in our portfolio

We were very active in the last quarter. Large share price movements in April and May brought many opportunities and we strove to exploit these to the maximum extent.

We sold three positions: Axis Capital, Lockheed Martin and General Dynamics.

In the case of all three companies, the main reason for selling was the fact that we had other, more attractive opportunities open to us. In the cases of Lockheed and General Dynamics, a second reason factors in, and that is that the main customer of both companies is the United States government. It is possible that the U.S. federal budget may descend into chaos at the turn of the year, and we do not want to be affected by that. We would rather sell both shares in advance. Our overall holding period gains from owning these shares come to 57% for Axis, 30% for Lockheed and 4% for General Dynamics.

We have three new positions in the portfolio, all of them in the United States. In addition, we bought more shares in an additional five titles that we already had in the portfolio.

Among the short positions, we closed that in Lululemon Athletica with a gain of 21%. Lulelemon's share price dropped sharply and the company shifted from the category (as measured in sophistication terms) "very expensive" to that of just "expensive". Its potential for decline that springs in part from overpricing had partially run its course, and therefore we exited that short position.

In what phase do we find the market today?

Market development is largely cyclical. The stock market runs in cycles, the individual phases of which are:

Euphoria – Anxiety – Pessimism – Apathy –
– Deliberation – Optimism – Euphoria

And then it starts all over again. The duration of the cycle may vary greatly. If we take a period of euphoria as the start of the cycle, then the present cycle is in its fifth year. The previous cycle lasted for 7 years (2000–2007), and the one before that 20 years.

It is good to know approximately where we find ourselves within the current cycle, because history shows us quite plainly that the best investments are made in periods of apathy, which means at just such time as the majority of people dismiss investment as entirely inopportune. Stocks are not much in demand during periods of apathy and are therefore low priced. That is in accordance with our motto that **only truly unpopular assets can be really cheap.**

So are we in a period of apathy today? I believe so, and for three reasons:

1. Through the 20 years of my investment practice, I have experienced no less than seven global market crises, and **I do not recall people's views towards stocks ever being so negative as they are today.**

2. In the past two years we generally have seen record outflows of money from stock funds and record inflows of money to bond funds. This is a classic phenomenon accompanying periods of apathy. **The majority of people do just exactly the opposite of what they should do, as time later reveals.**

3. On the government bonds market we have witnessed a gigantic bubble, which is most likely near its climax. **The overpricing of bonds, as the polar opposite of stocks, is consistent with the notion of a present period of apathy towards stocks.**

I am convinced that in future we will live in a world of much higher interest rates than today. This will wholly decimate bond portfolios, and it will greatly disappoint bondholders. Evidently, few people realise how quickly, for example, a 10-year bond can lose a quarter of its value. One need only take a look to the south of us.

At the beginning of June, the yields from bonds in countries like the United States, Great Britain, Germany or the Netherlands were at historic (or at least several-hundred-year) minimums. Their real values were mostly negative. Masses of investors unthinkingly are moving huge sums of money into them, which situation represents for me an incomprehensible misconception as to the security of these investments. So long as we lean on our argument from the outset that an investor's main enemy and also incentive is inflation, then bonds represent today an extraordinarily risky investment that carries negative real value.

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The final resolution of the present debt crisis in the majority of countries must contain elements of financial repression. One of the main such elements will be inflation, and holders of government bonds will be the main victims. Negative real rates of return on deposits and government bonds ultimately show that this repression already has begun.

When interest rates begin to rise to rise – and it is only a matter of time before that will be the case – then bonds will start to stagger and investors (who will lose money on bonds thereafter) will commence, in droves, to shift their money elsewhere. A great deal of it will go into stocks. That will mark a major inflection point in the market's development and a change in investor behaviour and thinking. When this break point will occur, no one knows. It could have come last month; it could arrive next year, perhaps even later. It may, however, occur abruptly and unexpectedly. Therefore, it is better not to try to forecast it precisely but rather to prepare one's investments for the change in advance.

Now, we are aware that to have a view too much in advance is, in essence, indistinguishable from having an incorrect view. **But, it also is much better to be somewhere a little bit early than entirely too late.**

In closing, a paradox: the majority of investors today are extraordinarily apathetic towards stocks. At the same time, after last year we are recording the greatest interest from new investors into our fund. In order for an investor to be successful, he or she must often do just the opposite of what the majority does. Our views are perhaps in the minority, but they certainly are not unique.

I wish you a pleasant summer.

Daniel Gladiš, July 2012
