Dear shareholders,

World stock markets and Vltava Fund both experienced their worst quarters since the end of 2008. Global indices and the fund's NAV both fell by nearly 16%. Let's take a look at the political-economic backdrop of the crisis, our activities during the past quarter, and our outlook on the state of the market and its prospects.

When the "first Greek crisis" broke out a year and a half ago, we told ourselves that if EU and euro zone politicians would show a tendency to defer rather than address the problem and a desire to continuously wrestle against the reality that is the market, then one possible scenario that could develop – and in fact one of the worst – would be thus: the debt contagion from Greece expands also to other euro zone countries, causing bond prices to drop. This creates pressure on banks' balance sheets. The banks, not knowing which of their peers is affected and to what extent, will thus stop trusting one another and interbank lending will cease. Money and bond markets will exhibit a similarly cautious approach, and banks will begin to face large problems with their financing. The last thing in which they will be interested under such circumstances is to provide new loans. Instead, they will be compelled to amass liquidity, reduce leverage, and boost capital. This will present a rude awakening for banks' shares and lead to a lending contraction and credit crisis. That, in turn, would be reflected in the real economy by a surprising drop in economic activity. This all occurred, even though it need not have.

The blame lies exclusively with euro zone politicians. Few people have high opinions of these politicians to begin with, but all were shocked by their incompetence and indecision. After all, they had a 3-year-old lesson from the US from which to have learned something! the Americans at that time had faced an even more threatening and urgent case. They were very fortunate, however, to have had Hank Paulson, former CEO of Goldman Sachs, as Secretary of the Treasury. Paulson understood how financial markets work, was accustomed to making decisions, and had a high level of competence and authority. He forced banks to increase capital, allowed some to fail, compelled others to merge, and bought a large package of risky and illiquid assets from the banks, thus untying their hands and enabling them to continue to conduct business.

The majority of euro zone politicians, on the other hand, did not operate in the real world. They have no knowledge of financial markets worthy of mention, and their competencies are unclear, limited and overlap one another. What's more, Europe lacks a leader. Is it Barroso? Van Rompuy? the Merkozy duo? All these people have staked their careers on building the EU and its common currency. They have proven unable to move beyond this and are living in denial – and it is costing the rest of us money.

Okay, attacking European politicians is very easy and in vogue. They do make an easy target, and thus I do not wish to get carried away. More important is how to get out of this situation. There are essentially two ways.

The first is the way of bankruptcy. In this scenario, entities that could not survive due to their debts are left to go bankrupt. The first of these entities, of course, is Greece. Now, for states to go bankrupt is scarcely unthinkable. There have been hundreds of such cases in modern financial history. There are some states today that are almost continuously in default, which is to say unable duly to honour their commitments. At the turn of the 1980s and 1990s, nearly 15% of all countries around the world were in such situation. State bankruptcies are simply a fact of everyday life. They allow over-indebted countries to start over again; they give them the chance of a new beginning. Though many investors do lose money in such cases, the facts are that investing carries with it risk and that poor investing brings losses. The losses from a Greek bankruptcy would not be so drastic that investors could not handle them. By comparison, when stock markets undergo a significant correction, as they have this year, investors lose $5–7 trillion dollars and still survive. In the case of Greece, we are speaking of a sum that is perhaps one-twentieth that amount. The financial system is definitely able to bear such a loss. Banks will write off losses and, in many cases, will have to increase capital, but Europe will be faced with one less problem. Of course, plenty more will remain.

The second way is that of a financial tsunami. This could lead to a massive credit line being extended from other central banks around the world. In the interest of aiding Europe, and in turn also themselves, central banks worldwide – from the largest (US, Japan, UK) to those in the middle (e.g. Brazil, Russia, China, South Korea, Canada, Norway) – could unite to provide the European Central Bank a vast sum of resources with which the ECB could, over the course of several years, purchase bonds from weaker euro zone countries and possibly even recapitalise certain banks. This would only happen provided austerity measures were adopted in the majority of these countries, leading gradually to surplus budgets and to an actual decrease in debts. Debts must certainly be reduced in any case, but ECB buying would provide countries the certainty that they will be able to finance themselves under acceptable conditions until they are able to put their balance sheets in order. Unfortunately, they do not have such certainty today. As regards size, the credit line would have to be large enough to preclude even the slightest doubts as to the success of the entire plan. Thus, we are speaking about an amount of at least EUR 2 trillion, but more likely EUR 3–4 trillion. That is a lot of money and represents a solution that is today unlikely and a bit extreme. On the other hand, it is clear to see that the pressure from non-European states on their European counterparts is increasing. They are concerned about their own stability and prosperity.

It is still possible, of course, that the situation will spiral of control (imagine Barroso, Van Rompuy, Merkel and Trichet sitting above a nuclear reactor and gradually pulling out the graphite rods…) and the market will have to sort itself out. As I have already mentioned, after all, the solution is in the hands of the euro zone politicians.

Let us now return to our fund. We were very active in the third quarter in terms of the number and volume of transactions. Although we generally do not give a detailed account of our transactions, we would now like to demonstrate in greater detail what was our reasoning during such large market fluctuations and how we conducted business.

During the last weekend in July, we came to the opinion that the likelihood that markets would drop sharply had risen drastically. Now, statistics show that it is virtually impossible accurately to predict large market corrections. Markets may drop more markedly on any given day, but for the most part they do not. One cannot rely on being able to predict the precise moment when a downturn will begin. The actual trigger mechanism – that infamous last straw – can be anything that is unpredictable. The basic condition for a collapse in any system, including stock markets, is that the system must show signs of instability. We based our assumptions on this consideration. It seemed to us that the markets truly were showing pronounced signs of great instability. On Monday, 1 August, we therefore took a short position in a broad market index. (A short position performs in a mirror image of the market. It rises when the market falls, and vice versa.) the market began to drop sharply in almost no time. We are aware that we perhaps showed more luck than discernment, but that did not spoil our delight when we closed the position at the end of August. The gain from this transaction reduced the decline in the NAV for August by 3% and earned us as much new cash. Our only regret is that we should have opened a much larger position, but hindsight is always 20/20.

In past reports, we have described how we hold quite enough cash and how better opportunities would certainly present themselves in time. The first of these came during the August downturn. Some shares on which we have long been waiting dropped to prices that met even our demanding criteria. We would be stupid not to take advantage. Even while acknowledging that given time they could be even less costly still (though that is always the case), we acquired two new larger investments – one in the UK and one in Israel. In both cases, we expect an average return on the investments in excess of 20% p.a. over the next few years. We also purchased additional shares of certain companies already in our portfolio.

We sold out three positions:

Steinhoff. We have not been pleased with this company's continually growing indebtedness. For us, this represents an unnecessary risk and thus we decided to sell the shares and collect an approximately 60% return for the holding period.

For the same reason – increasing debts – we sold our shares in **Atrium Innovations**.

It may come as a surprise to some that we also sold nearly all our shares in **PepsiCo**. In this case, the reason was different. While a number of stocks fell in August by 15%, 20% and even more, PepsiCo's shares actually rose slightly. They thus became relatively expensive as compared to other available opportunities. The money from PepsiCo was reinvested in other, more attractive stocks.

After a brief period of calm at the turn of August and September, the situation on markets began to worsen further. Thus we once again opened a short position, though this time a much larger one than in August. Our timing was poorer, however, and at the end of September we closed the position with zero gain. Nevertheless, it served its purpose by significantly reducing the risk in our portfolio. You may now ask why we even closed it at all, particularly considering what I have stated at the beginning of this report. So why did we not keep the position when the market situation remains so unclear?

There are several reasons:
1. Holding the position has its costs.
2. Markets have a long-term tendency to rise, and thus time would play against us.
3. The risk and return of each investment is primarily a question of price. At the start of August, markets were much higher than they are today and the potential return on such a short position as compared to the risk was much better than it is today.

A short position cuts both ways. Sooner or later it becomes necessary to close the position, and therein lies the risk of irrecoverable loss. In contrast, long positions in theory need never be closed. Even when a larger, transitory drop in prices occurs, the risk of an irrecoverable loss need not necessarily ensue. We generally avoid transactions that can cause irrecoverable losses. For these reasons, we have no such position at the time being. At the same time, however, we appreciate the fact that the situation may continue to waver and we are thus prepared to adapt accordingly.

At the close of September, we bought additional shares in Asian Citrus. On the last day of the month, someone began selling these shares very aggressively and they therefore fell by 43% in the first two hours of trading. We have held Asian Citrus shares for five years, we know the management personally, and, unlike a number of other Chinese companies, we have a very positive opinion of the firm.

How is it possible for a stock to suddenly drop by 43%? Was the seller forced to sell? Did someone make a mistake? This was certainly not a case of prudently liquidating a position. It is possible that the fact that it was the last day of the quarter and that on the previous day the market in Hong Kong had been closed due to typhoon had an influence. Whatever the cause, for us it represented an opportunity to purchase Asian Citrus shares at an exceptionally low price. At one point, the shares were being traded at a price corresponding to the amount of cash the company has in the bank. Asian Citrus has no debt, and that means that an investor could buy into that cash and obtain as a bonus three orange plantations with over 3 million trees and a factory for juice production. Such opportunities do not appear very often, and thus we purchased shares during this large decline. Coincidentally, the same opportunity for shares in Asian Citrus also had presented itself to us in October 2008. At that time the seller had been forced to sell, and, as we were one of the few buyers, we had then been able to purchase shares at their historic low (unsurpassed to this day). In the following two years, the shares rose tenfold.

The fluctuations in Asian Citrus share prices on the last day of September present a beautiful example of how the market is often inefficient, the opportunities that can bring, and how little short-term price fluctuations reflect actual value. Asian Citrus shares were down 43% two hours after opening. They closed out the day in Hong Kong at a price of minus 27%, while the same shares concluded the afternoon in London down only 7%. The price from Hong Kong was used for the NAV fund's calculation. This one-day movement in Asian Citrus shares alone reduced the fund´s NAV by 4%. The paradox in this situation is that had Asian Citrus shares not fallen by so much on the last day of the month the fund's NAV would have been 4% higher, but we would not have had the opportunity to make such an excellent investment. We would gladly welcome such situations more frequently.

Finally, let us take a moment to look at the current state of the markets and outlook for the future. This year can be characterised as one of general downturn in the stock markets. To put it simply, it could be said that markets fell by one-fifth off their cyclical peaks. Some more, some less. In a historical context, this represents nothing unusual. We would be hard-pressed to find a longer period in history when market growth was not similarly interrupted by a large drop. On the contrary, these declines are a phenomenon recurring at greater or shorter intervals – and particularly when preceded by pronounced growth. From a historical point of view, therefore, the market is not acting abnormally; we have simply found ourselves in a bear market phase. This, of course, is no great revelation, and so I state it simply as a basis for further reflection.

The important question is in what phase of a bear market do we find ourselves? We must be aware that markets develop in a cyclical manner and that this bear market will come to its own end. Every bear market can be divided into three phases, as aptly described by Howard Marks. In the first phase, the majority of investors continue to be optimistic. Although the pessimists are few, they have already come to realise that a worsening of the situation hangs on the horizon, they have seen the first problems, and they have begun selling. In the second phase of a bear market, the majority of people now see that the situation is worsening and an altogether negative mood prevails. In the third phase, everyone becomes convinced that this bad situation will last forever and that there is no hope for improvement. As concerns stocks, the majority of investors conclude that stocks are an absolutely unsuitable instrument for investing. History unequivocally indicates that this is the ideal situation for investing in stocks and that the subsequent returns are more than fair.

The first phase of the bear market took place in the winter and spring. Today, we are clearly at least in the second phase and some days on the markets are showing distinct signs of the third phase. Such days are those when absolutely everything drops – all stocks, gold, copper, oil, all currencies against the dollar – and the only things that rise in price are German and American government bonds. These are the signs that investors have capitulated, which is itself a coincident indicator of a bear market's culmination.

As regards our portfolio, we have long avoided banks and during the Arab Spring we withdrew from oil companies and even earlier from distinctively cyclical sectors and markets. In contrast, we preferred high quality companies predominantly from developed markets. Despite this conservative portfolio structure, we expect a gain of around 23% p.a. in future years. Our portfolio last had such a high expected return in April 2009. Since that time, and even including this year's downturn, the portfolio return has been 100%.

Today it is possible to find quality companies whose shares are priced lower than they were during the 2008 crisis even though their profits are considerably higher. After some time, it is again possible to put together a high-quality conservative portfolio with a truly high expected return. We are aware that markets may continue to fall and that inexpensive shares may become even still more inexpensive, but that possibility will exist always.

It is worth mentioning here a momentous step taken by Warren Buffett just last week. He announced that his company, Berkshire Hathaway, will be repurchasing its own shares. The main reason is their low price. Even so, one question comes to mind. Would Buffett buy in shares if he thought that markets would fall still more sharply? I think not. I think he would prefer to hold cash and to purchase shares in other companies on the market.

If Vltava Fund were a corporation, like Berkshire Hathaway, then we unquestionably would repurchase our shares, too. Given current prices and the portfolio structure, they represent a very attractive investment.

Daniel Gladiš
3 October 2011

P.S. *Occasionally people ask me to recommend a good, current book about investing. There are a great many such books, and at least 30 a year are worth reading. Here are three of the best:*

Two from this year:

John Mauldin, Jonathan Tepper – Endgame

Howard Marks – the Most Important Thing

And one from last year:

Anthony Boeckh – the Great Reflation

VLTAVA FUND

The information contained in this letter to shareholders may include statements that, to the extent they are not recitations of historical fact, constitute "forward-looking statements" within the meaning of applicable foreign securities legislation. Forward-looking statements may include financial and other projections, as well as statements regarding our future plans, objectives or financial performance, or the estimates underlying any of the foregoing. Any such forward-looking statements are based on assumptions and analyses made by the fund in light of its experience and perception of historical trends, current conditions and expected future developments, as well as other factors we believe are appropriate in the circumstances. However, whether actual results and developments will conform to our expectations and predictions is subject to a number of risks, assumptions and uncertainties. In evaluating forward-looking statements, readers should specifically consider the various factors which could cause actual events or results to differ materially from those contained in such forward-looking statements. Unless otherwise required by applicable securities laws, we do not intend, nor do we undertake any obligation, to update or revise any forward-looking statements to reflect subsequent information, events, results or circumstances or otherwise.

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Before subscribing, prospective investors are urged to seek independent professional advice as regards both Maltese and any foreign legislation applicable to the acquisition, holding and repurchase of shares in the fund as well as payments to the shareholders.

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.

Historical performance over any particular period will not necessarily be indicative of the results that may be expected in future periods.