

AN ATTEMPT AT A SMALL GLANCE INTO THE FUTURE

Dear shareholders,

In the third quarter of 2016, the Fund's NAV grew by 6.6%.

Prophecy at the stove

"Young man, have you ever seen a mine? It's a hole in the ground, shafts going up and down and side to side. Now, a mine can be flooded, it can collapse, but no one can take it away!"

Every Czech knows this splendid excerpt from "The Visionary", an absurdist one-act play by the great (albeit entirely fictional) Czech playwright Jára Cimrman. (We also know today, by the way, that even a mine can be taken away.) At the centre of the action, the farmer Hlavsa is foretelling the future from peering into a red-hot stove to the Prague coal baron Ptáček. We have often said to one another that it would not be a bad thing to have such a stove for reading financial markets. Although we unfortunately do not possess one, let us at least imagine what revelations we could expect to find there.

Revelation one: indebtedness

Every consideration as to long-term global development should probably start with a look at the key countries' indebtedness. The following table shows the development of national debts as a proportion of GDP in major developed economies between 2006 and 2015.

The US, for example, had a national debt equal to 64.8% of GDP at the end of 2007, which in hindsight was the last relatively calm year before the Great Financial Crisis. A mere 2 years later, which is to say just after the crisis, the debt was one-third higher, at 87.1% of GDP. At the end of last year (i.e. after 6 more years of "economizing and saving"), the debt was higher by another one-fifth: 104.1% of GDP. In just 8 years from 2007, it grew by an incredible 61% and the debt continues to increase.

The development in other countries has been in the same direction. The most indebted by far is Japan, and debt is growing the fastest in Spain and in the UK. Only Germany slightly defies this trend. Although it, too, has a high debt, Germany's debt is the lowest among those countries listed and it has been decreasing for several years (a question remains as to how much of a negative effect will occur due to the mass influx of immigrants). It is interesting that the unexpected crisis in 2008 increased the debts by an average 29%, and the following 6 years of economic expansion, low interest rates, and massive pro-growth stimuli brought another 29% rise. This is an incredibly alarming state of affairs. Debts have not been diminished successfully even under the relatively favourable economic conditions.

Table 1 - Key countries' debts (% of GDP)

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
US	63.9	64.8	76.0	87.1	95.2	99.4	100.8	101.1	102.9	104.1
Japan	166.8	162.4	171.1	188.8	193.2	209.4	215.4	220.3	226.1	229.2
Germany	66.4	63.6	65.0	72.5	81.0	78.4	79.6	77.2	74.7	71.2
UK	42.4	43.5	51.7	65.7	76.6	81.8	85.3	86.2	88.2	89.2
France	64.4	64.4	68.1	79.0	81.7	85.2	89.6	92.4	95.3	96.1
Italy	102.5	99.7	102.3	112.5	115.3	116.4	123.3	129.0	132.5	132.7
Spain	38.9	35.5	39.4	52.7	60.1	69.5	85.4	93.7	99.3	99.2

Source: www.tradingeconomics.com

Table 2 – Growth in indebtedness in recent years

	2006	2007	2008
US	136 %	120 %	163 %
Japan	113 %	121 %	137 %
Germany	109 %	98 %	107 %
UK	155 %	136 %	210 %
France	123 %	122 %	149 %
Italy	110 %	118 %	129 %
Spain	135 %	188 %	255 %

Why are debts a problem?

In the Czech Republic, we have heard politicians proclaim that “debts need not be repaid” and “there are sources enough”. But that is absolutely not the case. Long-term deficit operations and amassing debts is possible only until the market is no longer willing to finance it. Once the market’s willingness breaks, a swift end must follow. We need only go back to the book by Reinhart and Rogoff entitled *This Time Is Different* to be reminded of dozens of similar examples from history. The problem is that it is impossible to estimate beforehand at what level of indebtedness the market will lose confidence. Moreover, this level is not the same for every country. If the market is still able to tolerate Japan’s national debt at the level of 229% of GDP this does not mean that other states can count upon the same. Many countries in the past have been forced to declare bankruptcy with debts at only a fraction of that level. According to Reinhart and Rogoff, more than half of state defaults were at debt levels under 60% of GDP.

If we consider that national debt constitutes a substantial burden on state budgets, diminishing governments’ room to manoeuvre, pushing out private capital, suppressing economic growth, and raising the risk of potential insolvency, it is evident that debt and its size are potentially a great problem. The current debts of the major developed countries are simply too high, even leaving aside questions as to their immense future liabilities primarily for pensions and healthcare. These debts are not included into measures of the national debt – but they should be. Companies which have pension liabilities to their employees must state these on their balance sheets. They must measure and continuously finance these debts according to certain rules. If the same measures were to be applied to state finances, we would be shocked at how high are these

debts. In many countries, their national debts would multiply several times over!

If you have masochistic inclinations, you can read the article by Jagadeesh Gokhale, formerly a senior fellow at the Cato Institute, entitled *Measuring the Unfunded Obligations of European Countries*. Gokhale has long been examining this problem, and according to his calculations the present value of future uncovered liabilities in the EU is on average 434% of GDP! Spain is the best off, at 244%, while Poland is in the worst shape with a figure of 1,550%! These numbers are downright terrifying. Moreover, those figures are from 2009. They will be even higher today, as the debts have continued to grow and the interest rates used to discount future liabilities are lower.

There can be no doubt that debts are too high and must be somehow reduced over time. So far, the only thing governments have to show for themselves is their endeavours to resolve the debt problem by amassing still more debt. Isn’t that great! It is as if an alcoholic can be treated by ever larger doses of alcohol. Warren Buffett at one point, probably with a bit of exaggeration, proposed to resolve the problem of swelling US indebtedness by enacting a law forbidding any politician who ever voted for a deficit budget from re-election. I would agree. That would solve a lot.

How to decrease debt?

The size of the debt relative to GDP can be reduced in essentially three ways. The first is by rapid economic growth. A briskly growing economy puts a smaller burden on the budget, and GDP can grow more rapidly than the debt. Thereby, the growth in debt relative to GDP can diminish. This is the ideal scenario, of course. Unfortunately, it is practically out of the question for most developed economies. If we look back to the previous table, we probably would not be surprised to see that the debt of the selected countries increased by 29% over the two worst crisis years. This could have been expected. An unpleasant finding, however, is that even though the global economy operated in a relatively favourable climate over the past 6 years, indebtedness has continued to grow relatively quickly.

Economic growth is still too slow to decrease debt all by itself. GDP growth in developed economies has been slower since the Great Financial Crisis than in any

other equally long period since the Great Depression at the turn of the 1920 s and 1930 s, the growth in productivity has been the slowest since the start of measurement, and corporate investments still remain below their long-term average. In my opinion, the main reasons for slow growth are the government role in the economies that is too great and still expanding, incredible bureaucracy, omnipresent regulations, too-low interest rates, and the very magnitude of the national debts. Debts in most countries are simply so high that they very nearly thwart rapid economic growth altogether. Debt will definitely not be reduced in this manner.

The second possibility is to write off the debts, and the third is to let them be erased through inflation. The stove clearly portends the latter, and we will come back to that in a moment.

Revelation two: interest rates

If we were to have a single piece of advice for future generations of financiers, I would recommend for this message in a bottle to be: "Do not touch interest rates!" If there is a quantity in economics that can be denoted as crucial it is the price of money. If this is kept at the equilibrium value as determined by the market it will well reflect the relationship between supply and demand for money, allow risk to be evaluated correctly, and allocate resources properly. If, however, interest rates are so deformed by massive central bank interventions as they are today, then not only will rates fail to fulfil these roles but they also will cause extensive damage and give rise to unexpected negative side-effects.

We see something similar in physics. If we move at relatively low speeds, then we can practically consider mass to be constant and time to be flowing at a constant rate. If we reach very high speeds, then mass grows with increasing speed and time slows down. The original relationships cease to be valid. It is the same in finance. If a negative sign appears before a number representing interest rates, then we enter into a different world.

It is precisely into such a world that we have been led in recent years by the policies of large central banks. (Central banks of small countries such as the Czech Republic are pulled in the wake of decisions by the large countries' central banks to such a degree that

blaming them for the current state would be unfair.) The first and most visible response to the Great Financial Crisis by central banks was to cut rates. The basic supporting argument seems rational at first glance: Lower interest rates support economic growth. If we talk about normal levels of interest rates (as we do of low speeds in physics), this apparently works. But when we get to rates that are nominally around zero or even below zero, and in real terms deeply negative (equivalent to high speeds in physics), then the effects are different.

Today's level of interest rates is markedly damaging the economy and hindering its growth. Abnormally low interest rates decrease consumption as they force people to save larger portions of their incomes because returns from savings are low. Abnormally low interest rates diminish banks' profits, have a negative effect on their capital strength, and thereby reduce their willingness and ability to lend money. In contrast, economic growth depends upon the availability of loans, and without credit expansion the economy scarcely grows. Abnormally low interest rates decrease interest costs on national debt and therefore provide governments with a false sense of security and comfort. Governments love this situation, because it facilitates what they do best – putting problems off to be solved in the future. A Pyrrhic victory. Last but not least, abnormally low interest rates cause risks to be evaluated improperly and – partially by intent and partially by inescapable forces – assets to be allocated inefficiently.

Dead end

When I look around it seems the only ones who do not see this state of affairs or refuse to admit it are the central banks themselves. For example, when the Bank of Japan introduced the -0.1% rate for bank deposits in the spring, the share prices for all Japanese banks fell by nearly one-half almost overnight. The ECB for its part repeatedly declares how its negative rates are helping European banks. One only has to look at the development of profits, returns on capital, and European banks' share prices to see that exactly the opposite is true. Wherever one looks one sees the harmful effects of low interest rates. How is it possible that central bankers do not see this?

My purely private and unsubstantiated opinion is that they do know this but must not admit it in public. And

who would voluntarily admit that they had led their country into a dead end? Normalising rates is not at all simple, and in many cases it is not even possible. What rates are normal? To take an example, if inflation is 1% then short-term rates cannot be zero. Short-term rates must be positive in real terms, let us say 2%, and long-term rates should be at least 3–4%. Even such historically low rates would bring immense financial difficulties to certain countries, however. For example, Japan has a debt of approximately 230% of GDP. A rise in rates by 1 percentage point would mean an increase of interest expenses equal to 2.3% of GDP annually (of course not immediately but rather gradually as the old debt would be continuously refinanced) and rates higher by 3 percentage points would mean interest expenses would grow by 6.9% of GDP annually. That is more than the current annual budget deficit, which is high already. Japan's current budget outlays are 62% greater than revenues (see the following table), and a rise in interest rates could cause a complete collapse of state finances. Other large developed countries are in similar positions. Their central banks see this, of course, and therefore they must keep the rates low come what may.

Table 3 – Budget deficits

	Government revenues	Government outlays	Outlays/revenues	Deficit/GDP
US	2,100	2,907	138 %	2,50 %
China	14,770	17,576	119 %	2,30 %
Japan	59,479	96,342	162 %	6,00 %
Germany	1,302	1,272	98 %	(0,70 %)
UK	673	742	110 %	4,40 %
France	155	194	125 %	3,60 %
Italy	49	61	124 %	2,60 %
Spain	416	465	112 %	5,10 %

Doubling up the bets

The longer rates remain at an artificially maintained low level the more damage they cause. In the end, central bankers will have to come up with something new. Practically the only thing remaining is to launch massive fiscal stimulation programmes together with the government and to finance these by newly issued money. Here is what this might look like: The government thinks of some infrastructure project (these always look good on paper and their

effectiveness cannot be measured), but rather than the money coming from taxes, as usual, it will be issued by the central bank. Or, for example, every citizen will get a cheque for EUR 500 from the central bank that needs to be spent within three months. It sounds crazy but debates about the form of these stimulus measures have actually been ongoing for a long time.

Politicians will immediately realise that they have discovered a perpetual motion machine. They will be able to spend money without needing to have taken it from someone. This is Nirvana to them, and once they start they will not know when to quit. On the income side there will scarcely be anyone to complain. Unfortunately, however, these stimulus actions cannot boost overall economic growth and society's wealth over the long term. This was beautifully and logically explained by Henry Hazlitt in his great book *Economics in One Lesson* from 1946. As you can see, this topic has been discussed for quite a long time already.

Revelation three: growing inflation

A probable side-effect of fiscal stimulus programmes financed by issuing money in combination with ultra-low rates will be accelerated decline in the value of money and higher inflation. Here is where push comes to shove. Textbook tools for fighting inflation – i.e. primarily raising interest rates and limiting growth of the money stock – will be unusable. Or better said, they could be used but only at the price of dramatic recession and impending collapse of state finances in some of the most indebted countries. The world simply cannot afford high interest rates due to the size of its debts. A question is whether central banks do in fact have such control over those rates as they try to pretend today or if they eventually will be overwhelmed by the market and relegated to an observer role.

In any case, central banks will have their hands tied for fighting inflation and will need to tolerate a combination of higher inflation and lower interest rates. Interest rates will be negative in real terms over the long term, as they actually are already in many places. That condition will just be much more pronounced than it is today. This will allow governments to survive even with immense debts, and it is also possible that due to high inflation brisk nominal GDP growth will allow the debt to decrease. Such situation will, however, have enormous

consequences. Some might even like the situation as negative interest rates allow for reducing debt generally, but this will be paid for dearly by eroding the real value of people's savings. This actually is occurring already today. There is a huge transfer of property from the private sector to the state. The population's middle and lower classes are the ones primarily affected, and I do not understand how it is possible that people are not revolting against this.

The main objective for us as investors, however, is not to change the world but rather to try our best to invest within the conditions existing in our world and as they will exist in future. If we accept the thesis that we can expect a period of negative rates in real terms, then let us think how the basic asset classes may fare in such an environment. History as well as the world today provide us with certain guidance.

Historic returns

In one of my previous letters to shareholders entitled Risk-free Stocks, I used a graph from Jeremy Siegel's book *Stocks for the Long Run* which clearly shows that stocks not only provide the highest returns by far among assets – significantly exceeding those from bonds, bills, gold, and cash – but also that they have surprisingly the lowest deviation from their long-term trend. These are hard historical facts and thus scarcely worthy of discussion at length. There remains a question, of course, as to whether the future will be the same as the past. I am well aware that many predictions about the future will very soon be proven erroneous, but it is very probable that relationships between the real rates of return for the basic asset classes will be preserved.

If real interest rates will remain at an artificially low level, then real returns of other asset classes will accommodate this and will also move lower. Cash will still be the worst asset to hold over the long term, however, and stocks will be the best. Capital lent to someone for business purposes (e.g. a bank deposit or a bond) must over the long term bring a lower rate of return than capital invested directly into business (i.e. stocks). This has been the case in the past, and this should also be true in the future. The opposite situation would make no sense. If lending yielded better returns than did equity capital, then everyone would want to loan money to companies but no one would establish them.

Where is wealth created?

Recently, I got the idea to look at the list of the wealthiest people in the world according to Forbes and determine where their wealth had come from. Of the 50 richest people in the world, 48 had made their fortunes in stocks, and 2 in real estate. There is no one there who would have become breathtakingly rich by holding cash or gold or by purchasing bonds. Real wealth is produced in companies for the shareholders who own them, and it does not matter whether these are publicly traded companies such as Walmart, Amazon, or Berkshire or privately held companies such as Bloomberg and Aldi. The economic impact for their owners does not depend on whether or not the companies are traded on a stock exchange. Publicly traded stocks provide one way to obtain equity shares in companies, and it is a relatively easy way that is available to all.

A few years ago at Berkshire Hathaway's annual shareholders meeting, Warren Buffett talked about what instructions he had put into his last will and testament concerning the handling of his private portfolio beyond his Berkshire shares. These are very simple. The investment is to be made thusly: 10% cash and 90% stocks. I am not saying that we all need necessarily to agree with Buffett, but if you believe, dear reader, that Buffett is making a mistake, then the burden of proof is on your side.

Lesson from other countries

In the past 15 years we have been living in an environment of unusually low inflation (with the exception of such countries as Argentina, Venezuela, Zimbabwe, and just recently Russia), and it is easy to get the impression that this is a new norm, a new permanent state, that this time will be different from the past. The past, however, clearly shows that such calmer periods do not continue indefinitely. The question is not whether inflation will rise, but rather how much will we let it take us by surprise.

If inflation starts to increase, this will have a dramatic impact on the real value of various asset classes. A look at history will suggest how the individual asset classes will fare. A nice example is provided by Israel, a country which in the 1970s was in a situation such that it had committed to large military and social outlays and was unable to bear them. Israel sought the solution in monetizing debt, and the result was

inflation between 1972 and 1987 which pushed up aggregate prices by 10,000 times. The stock market index rose by 6,500 times over the same period. Although stocks did not maintain the real value of money, they did as a class fare incomparably better than did cash or bonds. The real value of these was completely annihilated.

Similar conditions of long-term high inflation occurred, for example, in Brazil, Argentina, Zimbabwe and the Weimar Republic. Among the investment assets described above, only stocks provide a path to survival in times of high inflation.

Three final questions

What I have described above will give rise to three basic questions in most anyone's mind: How probable is the described scenario? How high can inflation go? When will all this happen?

Of course, no one knows precise answers. As to the question of probability, I would say this: If any of you have an idea how it could happen that labour productivity would begin to rise at a faster rate, the negative demographic development would reverse itself, and states would diminish their role in the economy, return to the roots of capitalism, and start to demolish growth-stifling regulations, and if all this causes a dramatic acceleration of economic growth such that it allows for reducing the size of the debt relative to GDP, that at the same time there is a new and qualitatively higher type of politics refusing to amass debt, and that central banks withdraw substantially to the background and let the market be the market, then send it to us. I would be very glad to admit to being wrong! If not, however, I am afraid that the aforementioned scenario is very probable.

How high can inflation go? I would be very much surprised if inflation remains at just single-digit rates. Japan in particular, paradoxically a country that has not seen inflation in 20 years, is the first candidate for double-digit inflation. The Japanese government and central bank are presently trying hard to achieve at least 2% inflation, and so far they have not been successful. Considering their resolve and practically unlimited possibilities they will eventually succeed, but I am afraid that the idea of inflation obediently stabilising at the 2% level

will very soon be dispelled. Once the breaking point occurs in people's thinking, in the development of the currency exchange rate, and in the willingness of the market to finance the debt, inflation will on the contrary reach nightmare proportions.

The most difficult question to answer is when it will happen. Again, history teaches us that a situation usually looks stable for a long time before there is a breaking point from which there is no turning back. This moment will occur. It probably will strike very suddenly and dramatically. Unfortunately, it cannot be said whether it will happen next week or in 15 years. A long-term investor should prepare his or her investment portfolio in due time. It will be too late after we cross the breaking point. Stocks must play a large role in this "prepared" portfolio.

Everything described here we saw in the stove, but it may not mean anything at all. Perhaps it will turn out differently. On the other hand, as Hlavsa said: "Everything that the stove showed always came to pass."

Changes in the portfolio

We sold Oracle. We had held Oracle for several years, albeit with a small break when we had sold it only to buy it back soon thereafter at a much lower price. Our return for the first time was 18% and for the second time 33%. In total, therefore, approximately 57%. Considering the length of our holding period, it was a below-average investment that lagged behind our expectations.

From an historical perspective, Oracle's main business has been in its database systems. These were installed directly at the client's site. This was both labour- and cost-intensive and erected sizeable barriers against the customer's shift to another supplier. This was the source of Oracle's great competitive advantage, and the size of its profit margins corresponded to this fact. Today, increasingly larger numbers of licences are not installed directly at the customers' sites but are accessible in the cloud. This arrangement substantially lowers the barriers against changing the system and the supplier's competitive advantage. That means profit margins will undoubtedly be substantially lower in the future. Oracle is itself feeling this already, and therefore we preferred to get out of the stock.

The response of markets to the UK referendum brought several irresistible opportunities. Among other things, we took advantage of this situation to open one new position. It is an inconspicuous but very profitable Irish company. If only there would be several such Brexits every year...

Daniel Gladiš, October 2016

P. S. Third Czech Investment Conference

In November, we are organising the third annual Czech Investment Conference. You are all very welcome!

We look forward to meeting you at the Pyramida hotel in Prague during 10–11 November!

Programme and registration here:
www.ceskainvesticnikonference.cz

Our estimates and projections concerning the future can and probably will be incorrect. You should not rely upon them solely but use also your own best judgment in making your investment decisions.

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