

Dear investors,

Our fund's NAV grew by 21.5% in 2010. This is a very good result, both in absolute terms and in comparison to stock market movements, which were as follows: world +7.8%, US +12.7%, Europe +7.3%, Japan -1.2% and China -14.3%. Our return was hence much greater than that of the market as a whole. In addition, it was higher than our long-term target to earn a 10% average annual return, and also higher than the expected return at the beginning of 2010 (17%). Neither should we forget that we are (still) in a period of very low inflation, which was around 2% in the Czech Republic last year. Hence, our real return was almost 20%.

Our portfolio has undergone pronounced changes during the last two years. We sold a number of stocks (generally at decent gains) and bought others at lower prices. The majority of these new investments have had two common characteristics. They involve big, stable, high-quality companies, generally based in developed markets. We detailed our inclination towards quality in the previous report, and now I would like to focus on where and why we find new investments.

Our method of investment selection is called "bottom-up stock picking". This means that a company's quality, potential and share prices are of greatest importance. It is not crucial to the selection process in which country or line of business the company operates, and macroeconomic factors, too, play but a marginal role. Hence, the fact that we have no investments in Germany or Brazil, for instance, does not mean that our overall view of these countries is negative, while conversely our investments in Ireland or France do not reflect our opinion on those countries. The decisive factor is always the attractiveness of the individual investment, and if we have started accumulating several investments in one country or region it is due to the fact that the specific market offers several good opportunities and not because we hold a particularly positive view of the local economy.

Nonetheless, from time to time one should look up from the study of individual companies and pause to think about general developments in the global economy and individual countries. Just such reflection was associated with the rather pronounced shift in the regional allocation of the portfolio during the last two years.

Two years ago, one third of our portfolio was invested in China and only 8% in the United States. Today, only around 15% of our investments are in China but one third in the US. Our Chinese investments were on the whole very profitable and played a great part in the high returns we enjoyed over the last two years. We realised part of the gains and redirected the bulk of the funds which that freed up to American shares. In addition to stock valuation (some American stocks are much cheaper and of higher quality than Chinese), this also reflects our outlook on global developments. We will examine this topic in a bit more detail to give you an idea what our current position is and what you can expect from us.

There are three main reasons for this "China to US" shift:

#### 1. The Micro View

After the global crisis of 2008, the epicentre of which was in the western world, it became fashionable to condemn western economies as hugely over-indebted, unpromising, and burdened with a nearly bankrupt banking system and a self-indulgent population. With equal frequency, people pointed to the Chinese economic miracle. While all this is to some extent correct, most investors make the following error in their reasoning: They think that if the American and European economies are in such a bad state, then the American and European companies must also not be doing well, and therefore they do not invest in them. Conversely, the Chinese miracle is taken to mean that Chinese companies are doing well and that that is a good reason to invest. The record withdrawals from funds investing in the US and the record investments into funds investing in emerging markets, including China, illustrate that this is the way investors reason.

Of course, we think that their reasoning is incorrect. A more detailed look at the corporate world in the US suffices: American companies are doing very well and their profits illustrate this. In conjunction with investor pessimism, it is no surprise that the shares of a number of high-quality American companies with global operations and often almost dominant positions in their markets are trading at very attractive prices.

A number of Chinese companies, on the other hand, are very precariously positioned and are literally dependent on state subsidies for their existence. In combination with investor optimism, this makes most of their shares overpriced.

The company Interbrands publishes an annual ranking of the 100 biggest global brands according to their value. For 2010, Coca Cola, IBM and Microsoft are at the top of the list, as they were last year. Upon consideration of all 100 companies (of which 4 are also in our portfolio), it is undoubtedly noteworthy that the majority are from the US, that the values of their brands are several times higher than are those of their non-American counterparts, and that China, Russia and Brazil are not represented by a single company.

Whatever we might think about the American economy, its corporate sector is very much prospering.

## 2. The Macro View

This is where we have the greatest reservations about China. The Chinese economy is a little like the Beijing Olympics. With only a bit of hyperbole, one could say that the Olympics captured the essence of the Chinese miracle. The opulent opening ceremonies were meant to demonstrate how far the country had advanced, the patriotism of the crowds stood in contrast to the government repression, and its first place in the medals count was proof for many that China had taken the place of the United States as world power number one.

But eventually another side of the Olympic coin came to light: misrepresentation of costs, an opening song sung by a different girl than the one on stage, state-organised enthusiastic cheering, dubious referee decisions in gymnastics, and fraudulent age information of female gymnasts.

The Chinese economic miracle also has its flipside. Most big companies, including banks, are owned or operated by the state, and national debt figures are distorted by not including half-secret consolidation banks, to which bad debt is commonly transferred. The currency is manipulated and misrepresents economic realities, the banking sector works very poorly, and more than 50% of GDP is made up of investments. In addition, investments are often pushed into completely nonsensical projects with zero

rate of return and into export sectors that survive only due to the undervalued currency. The economic imbalance in China is increasing quickly, and it is possible that all this might lead to a collapse of the economy. Indeed, many socialist countries tried to direct their economies in the past and without exception they all collapsed. Is it then at all possible for China to achieve what no other country ever has achieved and to turn economic theory on its head? All are entitled to their own opinions, but, as far as we are concerned, we prefer to bet on historical experience, and that is our yardstick for investment.

By the way, our view on China is not based merely on third-party information, but also on contacts and discussions with the management of companies that we own, or have owned, in China.

## 3. Corporate Governance

Corporate governance is the system for directing and controlling a company. The system defines the distribution of rights and responsibilities between parties involved in the company, such as shareholders, the executive management, statutory bodies, employees and customers, and other interested parties. In this field, the situation in China is rather turbulent. Managements often use very idiosyncratic interpretations of what is fair and ethical – and what is and is not in the interest of shareholders. They frequently misrepresent results, change auditors, and perform creative magic in the accounting. One must not say, of course, that all managements exhibit this attitude, but we believe more of them do than one might first perceive. If ever the Chinese economy and Chinese companies are hit by tougher times, many problems with company management will float to the surface. To quote Buffett, it's only when the tide goes out that you learn who's been swimming naked.

These and other reasons have made us very cautious about investing in China. We might be wrong, but we would rather miss some investment opportunities than to invest badly. The attitude of retail investors has strengthened our views, since, as the test of time has shown, they generally invest quite badly. Hence, they present a useful contrary indicator. Last year, they bought great quantities of shares on emerging markets, including China, and sold their American shares in similar quantities. We swam against this tide,

preferring to buy where others were selling, and sell what others were going crazy about. (Retail investors last year again bought bonds in record quantities, too, most probably putting them on the path to further disappointment.)

What happened concretely to our portfolio in the last quarter? We sold Oracle. We had held the stock only for a short while, since January, but the price went up steeply and so we sold. We realised a decent gain and obtained cash for better investments.

We opened two new positions, one in the UK and one in Japan. We used to have two investments in Japan, which we sold in autumn 2006, and since then we have not been able to find anything interesting there. Perhaps we will now. For now, both positions are small and we intend to build them gradually. We have a rule about stocks that are new to us: we prefer to buy slowly in order progressively to get to know the organisation and to dig into it more deeply. We know from our own experience that, even with the best possible research and analysis, things can be overlooked and underestimated. That is why we tend to approach new investments cautiously. Again, we would rather miss an opportunity than to go into something recklessly.

Sometimes we do miss opportunities by taking this attitude. It happened with Heineken. We started buying the stock in 2009 with the intention of proceeding slowly and cautiously. After our first purchase, however, the share price shot up sharply. Now it is 80% higher, which is great, but we only have few shares. Too bad for us.

In the case of companies that we know well and have followed for a long time, by contrast, we have no

reason to hold back. When we bought Microsoft some time ago, a company I had been following closely for almost 15 years, we invested CZK 100 million quite quickly and thus took off at full throttle. The share price development indicates that we did well. Microsoft shares were trading at an attractive price for the first time in those 15 years. Sometimes investment demands a huge dose of patience.

We do not know what is in store for us this year, but probably the best forecast is that share prices will fluctuate. This is what J. P. Morgan had answered when asked about the market some 100 years ago, and it is still valid today. This year will evidently be just as turbulent as last year (and evidently also those still to come). Again, we are drawing nearer to the bankruptcy of several countries, and we can expect great movements from time to time both in share prices and currencies, which is a good environment for investing. Now and again, uncertainty and the occasional price drop offer excellent opportunities. As last year, we intend to wait patiently for these opportunities, but we will not hesitate in seizing them.

It is highly likely that in a couple of years the shares in our portfolio will be trading at substantially higher prices than they are today. Considering our portfolio's present structure and low cost basis, we expect average annual returns of around 17% during the next few years. That is a lot more than the yields of bank deposits, bonds, or the photovoltaic systems that the media have been raving about. Moreover, it comes with incomparably lower risk and higher liquidity.

Dan Gladiš, 3 January 2011

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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.