GOING SHORT

Approximately 8 years ago, in 2011, my colleagues at Vltava Fund and I sat down and debated the following topic: If we were to manage the Fund for another 30 years, how in the future could we bring additional value for the Fund's shareholders above and beyond what would be possible by means of the investment strategy we are currently pursuing? Of the various possibilities raised, just one option remained in the end: taking short positions. We decided to commence doing so to a very limited extent and after approximately seven years to evaluate if we really could add value in this manner and whether or not we would continue with it into the future.

Our investment activity is not static but rather develops over time. We continuously strive to evaluate our results and to analyse successful and unsuccessful transactions or approaches. One could say we continuously force ourselves to question whether or not we are correct in what we are doing. It can be very dangerous when an investor stops questioning his or her own approach. We also strive constantly to learn new things.

Among these strivings is our pursuit of the plan to take short positions in individual stocks. Not only is practical experience the best school, it also provides immediate and abundant feedback. Our short positions in individual stocks were therefore a very real, albeit miniscule, part of our overall portfolio.

We have discussed short selling with you several times at our Shareholders' Meetings, and now, seven years after the aforementioned initial idea, comes the time to evaluate the success of this additional strategy.

Short selling

Our entire investment philosophy is based on a simple idea. What we pay (price) must be much lower than what we obtain in return (value). We say (and the history of the markets confirms it) that price and value are two different categories. For transient periods the two may differ significantly, but, over the long term, price has a strong tendency to follow the development of value. When we say that many stocks can be found that are priced substantially below their values, then, analogously, there must also be a number of stocks to be found whose market prices are substantially above their fundamental values.

Short selling endeavours to take advantage of those situations when price can be expected to follow value downward. The mechanics of these transactions are pretty simple. An investor borrows shares from his or her broker, sells them on the market, and holds the cash thus obtained. In future, he or she then buys the shares back using the cash acquired earlier and returns the shares to the broker. The profit or loss from this transaction (not including transaction costs) depends upon the development of share prices between the time of selling the stocks short and buying them back. In fact, this is just a mirror image of buying the usual long positions.

It follows from the preceding paragraph that one does not need additional capital for short selling. Therefore, if a fund's entire capital is invested in long positions and it makes money over the long term, and if several short positions can be added to this, then the profit from the latter may bring additional return, even at a lower net market exposure (which is defined as the difference between the sizes of all long and short positions).

Theoretically yes. The practical implementation, however, is not quite so simple. In looking back at the past 10 years, which is the period since the switch to our current investment strategy, we can see that the success rate of our long positions is approximately 9:1. This means we make money on almost nine out of ten stocks that we buy. The success rate of our short positions is not that high. In addition, short positions require a disproportionate commitment of time and energy. Our average long positions accounts for approximately 5% of the portfolio. When we pick well, profit may easily be 100–200%, which is 5–10% percent of the overall portfolio.

The individual short positions, however, must be much smaller. In our case, this was approximately 1% of the portfolio and there were only a few of these positions at any one time. A 50% return on a short position, which can be considered a very good result, therefore, means only one-half of 1 percentage point return for the overall portfolio. In addition, looking after short positions is more demanding than is managing long positions. It all begins with analysis of the company itself. Whereas on the long side we focus on companies with no crucial accounting, financial, or managerial problems, on the short side we seek out precisely such companies as do face these sorts of problems. Their analysis is much more time-consuming. Monitoring the active position and dynamic risk management also are much more demanding in the case of short positions.

All of this has led us to the conclusion that it is better to focus our efforts fully on the long side of our portfolio and not to open any new short positions in individual stocks. In accordance with market developments, we will close out the last short position we are still holding and instead will devote our full effort to the long side of the portfolio. One can make money in short positions, and they may be used to help in managing the portfolio's risk profile. Their benefit to us, however, seems to be inadequate vis-à-vis the effort and time they would require if they were to form a larger part of the portfolio.

This conclusion may seem self-evident, but our decision-making was more complex than this. The following are some of the arguments we took into account:

1. Individual short positions cannot be considered independently. Each constitutes a part of the overall portfolio, changing its characteristics and risk profile. Particularly in periods of more substantial market decline our short positions had very advantageous effects. They usually fell more than did the overall market, and thus they were a brake on the decline of the overall portfolio.
2. Seven years of seeking out and analysing potential short positions was an excellent learning exercise for us that perhaps elevated our own

analyses to a higher level. I believe that we can make good use of this knowledge in selecting long positions. When a person goes looking for something he or she does not want, this helps one to better recognise what it is that he or she really does want. We came to realise something that I call the short-selling paradox: Even though most investors would be better off not attempting to sell short, most investors would nevertheless benefit from trying to find stocks to short.

3. Short positions help increase the market's efficiency and improve its price formation function. Although a number of investors consider short selling to be some sort of wager on failure or an excessively negativistic approach to investing, we do not see it that way at all. In selling a stock short, an investor expresses not what he or she wishes would happen but what he or she thinks will happen. By the way, investors have lost much more money by praising overvalued stocks than by identifying overpriced ones. The market needs investors who sell short, and there should be many more of them.

Changes in the portfolio

Over the past year, we gradually narrowed down Vltava Fund's portfolio. Our objective was to further concentrate our investments into the most attractive titles even at the price of somewhat reducing diversification of the Fund's portfolio. Last year, we therefore bought one and sold a total of five stocks. The last of the latter was ITV.

Our original investment thesis could be summarised as follows: ITV is a company with a very strong position on its market, entirely dominant on the UK's commercial television market, and an important and well-established content creator. The company's main revenues are from advertising. Advertising revenues have been cyclically under pressure due to the coming Brexit and also due to an advertising recession in Europe generally. ITV shares seemed very cheap to us, and yet they were supported by a high dividend and free cash flow.

Unfortunately, it appears we did not fully appreciate the influence of the secular shift from traditional forms of advertising (TV) to digital advertising. This is why the company's value is stagnating, and it probably can be expected that this stagnation will continue in the coming years. Because we had bought the shares at really low prices, we did not lose out even when our assessment of the company's development turned out to be erroneous. Of course, we could have invested the money better.

Last year

Looking back at the past year, we have mixed feelings. On the one hand, if we take a look at our portfolio as a whole, the earnings of the companies we own have grown substantially (we expect them to grow further again this year). If we were a private equity fund evaluating our stocks using a pricing model based on their fundamental values, we would be reporting a respectable, double-digit positive result. Because we value stocks at their current market prices, however, their fundamentals are commingled with the psychology of the market. The latter can be unfathomable and may play the main role in the short term. After the equity markets hit their local highs in January, they essentially declined through the rest of the year, and that decline accelerated at the end of the year. 2018 was, in the end, our worst for ten years, during which we have been practicing our current investment strategy.

Our total return for these ten years was 273.6%, an average annual growth of 14.1%. For comparison, world stocks represented by the MSCI World index recorded an increase of 112.7% over the same period. Fundamental value of the Vltava Fund portfolio was raised to the new maximum last year and is currently 64% higher than our stock prices. For several of our stocks, the difference between value and price is close to 100%.

In such situations, a person keeps asking oneself what could have been done differently. The greatest danger is that an investor, under pressure of emotions and his or her own psychology, abandons his or her investment approach the logic of which he or she understands, tries to actively time the market, and then causes irreparable damage to the portfolio by means of such transactions. We are well aware of this and therefore try to be as little-active as possible. This may seem paradoxical, but the most difficult thing may be to do nothing in the face of fluctuating markets. History shows that from a long-term perspective this is a good approach.

In the spring of 1991, I was in New York for the first time. I was staying with some relatives of mine who both worked on Wall Street. This is probably one of the reasons I noticed at the time that the Dow Jones index surpassed the 3000 threshold for the first time in history. That was a big event, and there were inch-tall headlines in the newspapers proclaiming it. Today, this index stands at 8× that level. During the intervening time, we experienced two really deep market plunges (2000–2003 and 2008–2009) and a large number of smaller 10–20% corrections, such as we experienced twice in the past year.

Eight times is a really high return, but only those investors who remained patient and invested for the entire time could achieve it. Historical data suggest that investors who attempted to time the market, which means to improve their returns by trying to predict short-term market movements and to buy and sell their investments in anticipation of those, in the end achieved not eight times but on average just approximately three times.

We are striving to achieve something similar. We are not attempting to time the market and change the Fund’s portfolio accordingly. If some share seems sufficiently attractive to us, we buy it. If not, we do not. It is true that we take into consideration which phase of the economic cycle the company finds itself in, but this concerns the company’s fundamentals and not market timing. I always say that investing is a matter of probabilities. The probability that we succeed in finding fundamentally undervalued stocks is greater than that of our successfully timing the market. This approach works, but it requires a great deal of patience. In the words of Warren Buffett: “The stock market is a device for transferring money from the impatient to the patient.” It is during the deepest market slumps that the risk is greatest for some investors to run out of patience, throw in the towel, sell their stocks at low prices, and thereby transfer a part of the value they own to those who are patient.

What does Warren Buffett do in the markets in times like these? During the third quarter of last year, which is the latest for which such data are currently available, the Buffet-managed Berkshire Hathaway spent USD 14 billion in buying stocks. That was its largest quarterly purchase in a very long time. The majority of the money was used to buy shares in banks, which are companies sensitive to economic development, and prices were substantially higher in the third quarter than they are now. Time will tell how good those investments are, but it definitely does not look as though Buffet was any kind of pessimist concerning future development of the US economy.

Berkshire Hathaway's investment portfolio totals USD 333 billion. Of this amount, USD 18 billion is in bonds, USD 218 billion in stocks, and the rest in cash. In addition to that, Berkshire has an additional 250 billion invested in the shares of companies that are not publicly traded. Moreover, Buffett himself has practically all his assets invested in Berkshire stock. His investment strategy using primarily stocks has worked out excellently for Buffett over the past 60 years, and there is no reason to believe that the future will be diametrically different. We believe that stocks will remain the highest-return class of assets over the long term, even if sometimes it may not look that way.

I have all my investments in Vltava Fund and the Fund itself is fully invested. I have not the faintest idea about what direction markets will take in the near future, but if I look at the most recent ten years of Vltava Fund, I would not exchange today's portfolio with any portfolio from back then.

Daniel Gladiš, January 2019

For more information

Visit www.vltavafund.com

Write us investor@vltavafund.com

Follow www.facebook.com/vltavafund

Disclaimer :

This document expresses the opinion of the author as at the time it was written and is intended exclusively for educational purposes.

Our projections and estimates are based on a thorough analysis. Yet they may be and sometimes will be wrong. Do not rely on them and take your own views into consideration when making your investment choices. Estimating the intrinsic value of the share necessarily contains elements of subjectivity and may prove to be too optimistic or too pessimistic. Long-term convergence of the stock price and its intrinsic value is likely, but not guaranteed.

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 given 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.

This letter to shareholders does not constitute or form part of, and should not be construed as, any offer for sale or subscription of, or any invitation to offer to buy or subscribe for, the securities of the fund.

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.

The Fund is registered in the Czech National Bank´s list in the category Foreign AIFs authorised to offer only to qualified investors (without EuSF and EuVECA) managed by AIFM.

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

Returns for the individual investments are not audited, are stated in approximate amounts, and may include dividends and options.