



JAPAN AND LAPLAND

This summer, I had an opportunity to visit two places the names of which almost rhyme (and in fact their names in Czech differ by just one letter): Japan and Lapland. Although I had been in Lapland previously, this was the first time Japan found its way into my travel plans, and it was the 75th country I had visited. Wherever I travel, I always look at the world in part through my investing eyes. It is an aspect of my job conditioning.

My notion of an ideal vacation always combines the outdoors and physical activity, even though I am also interested in the cultures and histories of the places and countries I visit. It was in pursuit of just such interest that I was drawn to the Arktikum museum in Rovaniemi, Finland. There, I was immensely impressed by that part of the expositions comparing the lives of the local inhabitants from 100 years ago and today. A hundred years is a very short time in the development of a society, and it was incredible to see the enormous progress in the way of life that had occurred over that time.

A couple weeks later, as I was standing in the Edo-Tokyo Museum, I had the exact same feeling. Life in Japan is very different today than it was 100 years ago. Once again, I realized that people in general tend to underestimate the importance and enormity of long-term development and at the same time tend to overestimate the significance of short-term events. We all reminisce

nostalgically about past times when things were simpler and more pleasant, but perhaps that is just an expression of our unfulfillable yearning to be young again.

Would we really want, for example, to go back 100 years? It would be an immense step down in our standard of living. We would need to reconcile ourselves, for example, with the nonexistence of today's practically indispensable medications and a much poorer level of medical care. We would have to get used to the fact that meat would not be a part of our diets that is automatically and easily obtainable, that lives would generally be shorter, and that more newborns would not survive to school age. We would have to forget about the possibility of traveling easily and at will from place to place, forget about education's being accessible to everyone, get used to the occurrence of genuine poverty, and so on. It would probably also mean a step back in terms of pension security, general public safety, higher crime rates, fewer human rights, and the nonexistence of most public services.

If we truly had the choice, most people would not want to go back. Life today is incomparably better than it was 100 years ago. When we focus on facts, we quickly find out that the world is many times better off today than we think it is and, moreover, that it still continues rapidly to improve (as a reference, I can recommend the excellent



book *Factfulness* by Hans Rosling). Things are moving forward generally, even though they do so more rapidly for some people at some places and more slowly for other people in other places, which is why we can find various stages of development in various parts of the world.

The average European today has a materially much better life than did even the richest of Europeans 100 years ago. My grandparents' standard of living was lower than that of my parents. My parents' standard of living was lower than that of my generation, and my generation's standard of living lags behind that of my children's generation.

Investors and progress, part 1

Why am I writing about all of this? There are two reasons. First, I want to describe briefly what lessons an investor may learn from these things. Second, I want to describe how we as investors contribute to the progress of society as a whole.

I always say that one can learn a lot just by looking around oneself, seeing how the world works as well as how people perceive it. The way people perceive the world is then reflected in how investors (a subset of people) perceive the events on the capital markets (a subset of the world). The aforementioned tendency to overestimate short-term events and underestimate the importance of long-term trends is very strongly demonstrated in both cases. (Finance theory even has a name for this: hyperbolic discounting.)

On the one hand, there are the difficult-to-deny facts of long-term positive development in the society, general progress, and overall growth of wealth and living standards. It is very, very probable that this trend will continue. By incorporating this into their thinking, long-term investors will have latched onto something that they can for the most part rely upon.

On the other hand, there is day-to-day normal life full of events, twists, and seemingly crucial changes. In practice, most investors focus on these things, even though the future will very probably confirm that most of this information is of no consequence whatsoever in the long term. The study of history, including financial history, is an activity wherein an analyst sits in a comfortable chair, pointing a finger to past events that were key to further development. It is a bit like filling in a lottery ticket after the winning numbers already have been drawn.

If we as investors were to profit from short-term events, we would have to be able to recognize the truly fundamental ones in real time as they are happening. This is practically impossible, and even the effort to do so might bring very negative results, because in most cases it will transpire that one has overreacted to something that in the end will have been of no practical importance. We find it is much better to take the approach of betting on long-term expected developments in society.

Investors and progress, part 2

As investors, we are not merely passive users of the growth in society's wealth but also



actively contribute to it. A modern, well-functioning economy and society cannot get by today without a well-functioning capital market. Banks and insurance companies, for example, which are two basic and indispensable components of society, probably could not operate effectively at all without a well-working capital market.

The capital market is very complex and diverse. In its most rudimentary form, however, it has only two basic functions: It is used by companies to acquire capital for their businesses (the primary market), and it allows investors to trade with the resulting shares (the secondary market). A well-functioning capital market, then, enables not only the use of capital for commerce and value creation but also allows for capital to be used as efficiently as possible by enabling it to flow easily from one place to another based upon how attractive are the opportunities at a given time and place.

For the capital market to work well and efficiently and for it to allocate capital at low costs, there must exist a sizeable number of entities of various types. Vltava Fund is one of those entities. Our role in the overall system is twofold: we act as intermediaries and analysts. We collect free capital from investors who want to invest and then analyse the individual investment opportunities to determine those into which we invest the collected capital. Even though we are just a tiny cog in the gigantic global markets machine, I am very proud of the work we do and how all of us associated with investing in Vltava Fund contribute collectively to the

general progress, growth of wealth, and betterment of society.

Our combined money helps make possible the operation of companies in such diverse and necessary sectors as health care, insurance, finance, transportation, technologies, communication, defence, construction, and automotive manufacturing. These companies provide jobs to people, bring their products and services to market, contribute through their innovations and research to the development of society, and pay returns to us, the shareholders.

Every day we try to learn something new and then reflect the acquired knowledge and experience in our common investments. The world is in fact much better off than we often think it is, and it will continue progressively to develop. The world will be better and better, with or without us. But as long as we are here, we want to play an active part.

Changes in the portfolio

There were no significant changes in our fund's portfolio during the past quarter. We hold shares in 16 different companies. Ten of these will probably achieve the highest profits in their histories. The remaining six companies are prospering as well, and it is only a matter of time before their profits will exceed their heretofore highest levels. I know that many of you follow on your own how our companies are doing and so this is nothing new for you. Another question is whether or not these stocks are low-priced. The fact that a company does well – or even better than ever before –



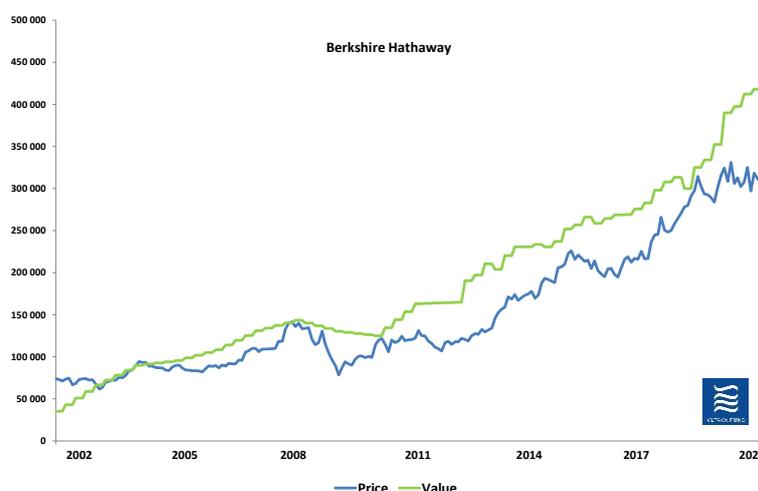
does not indicate whether or not its stock is low-priced. Only examining its stock price in the context of its fundamental value may give us a clue. So let us take a look at three of our key investments.

Berkshire Hathaway

Berkshire has been our largest investment for a long time already. In the time we have been holding it, the share price has almost tripled. At the moment, however, Berkshire shares are priced at their lowest for as long as we have been holding them. Berkshire is one of the largest companies in the world and also one of the most successful (if not the most successful of all). I am therefore surprised how little people understand what kind of business Berkshire actually does. I still keep meeting people who think that Berkshire is a kind of investment fund managed by Warren Buffett.

Berkshire is, in fact, a well-conceived and well-constructed conglomerate the whole of which is worth more than the sum of its parts. The business risk of Berkshire is by far the lowest among all large companies in the world. What’s more, the market is completely overlooking its unlimited long-term growth possibilities. In the long term, the Berkshire stock probably will outperform the American stock market index, and especially so in case of stagnating or declining markets. If I were to invest all my money into a single stock and not be able to change my decision for the next 10 years, I would choose Berkshire without any hesitation.

Berkshire is currently trading at nearly its historically lowest price-to-book multiple even though the fundamental value is steadily and increasingly rising above that book value as the company itself and its businesses develop over time. Because a picture is worth a thousand words, here is an update of a chart well known to you showing the price and value of a Berkshire share.



Sberbank

I bought Sberbank shares for the first time in 1997 on my own account. That means I have been continuously following the company for more than 22 years. It is incredible how the bank has developed over time, and in particular since 2007 under the leadership of Herman Gref. In terms of absolute profit, Sberbank is currently one of the world’s most profitable companies. By the way, Sberbank’s annual profit alone is on the level of Deutsche Bank’s market capitalisation.



I do not know any other large global bank with a similarly dominant and unwavering position as is that of Sberbank in Russia. Sberbank is surrounded by a very deep and broad moat which it continuously and successfully deepens. Although this is perhaps difficult to imagine in the case of a Russian bank, Sberbank is also a leading bank in its use of technologies. If you are interested, I recommend you read Sberbank's presentation from last year and you will be surprised about all the technologies the bank can use and develop.

Among the world's 100 largest banks (excluding Chinese ones), Sberbank ranks very low in terms of P/E and P/B multiples and leverage (asset/equity ratio) and among the tops in terms of ROE, ROA, dividend yield and cost/income ratio. Even though our return on Sberbank shares already exceeds 60%, the current valuation at 1.3 times book value and ROE of 24% mean it is still a very cheap stock. Its P/E of 5.5 and dividend yield of 7% only reinforce this. With ROE of 24% , the book value doubles every three years (before dividend payments).

BMW

We have been expecting more from our investment into BMW. To date, our return is around zero. Nevertheless, our view on this stock remains so far unchanged. Its current valuation indicates, in our opinion, the considerable irrationality occasionally seen in stock markets. BMW broke its own record last year in the number of cars sold, and this year will probably be another record-breaker.

Nevertheless, the markets price BMW shares as if the company were facing life-or-death challenges. Let's look at the numbers together.

BMW can be divided into two parts: BMW Bank and BMW Auto. BMW Bank can be valued like any ordinary bank on the basis of its ROE and book value. With ROE around 15%, BMW Bank deserves a valuation of at least 1.5 times book value. (ROEs of Western European banks are scarcely half that.) So, we come roughly to EUR 23 billion. BMW Auto has net cash (meaning the company's total cash after subtracting all debts) of about EUR 15 billion. The value of BMW Bank + net cash together thus comes to EUR 38 billion. BMW has 657 million shares in issue, so EUR 38 billion means EUR 57 per share.

We own BMW preferred shares, which are priced at EUR 50 per share. By buying these shares, we get BMW Bank and the net cash in the amount of EUR 57 plus BMW's whole automotive business, including research and development, manufacturing, distribution and the brand, FOR FREE! *Forbes* magazine estimates that the BMW brand is worth EUR 30 billion, and the book value of BMW Auto is EUR 58 billion. BMW Auto's net income for the past 3 years came to EUR 15.7 billion, and the average return on capital employed (ROCE) of the automotive segment was an incredible 67%. All this we get for free in buying the stock. And not even for free but for even less than free – in fact minus EUR 7 per share. If somebody wants to give us something very valuable for free and then add



in some extra money for us, it is hard to say no, is it not?

The BMW share's current market valuation is close to that seen during 2008–2009, in the middle of the Great Financial Crisis. Even if we were on the brink of a similar crisis, which we probably are not, the share price already provides for that. Today, we are in the declining phase of the economic cycle. So far as global automotive sales are concerned, however, the overall decline will probably not be so striking as 10 years ago because the accumulated excesses in the economy were much greater at that time than they are today. BMW's preferred stock has a dividend yield of 7%. In hedging the euro, in which currency the stock is traded, we make 2% a year. This puts the total annual yield at 9%. Considering all these parameters, BMW shares are a good investment even if the price will never rise in the future. There is so much pessimism built into the share price today.

In a private transaction, such a price would be unimaginable. Only stock markets sometimes offer such opportunities. Berkshire, Sberbank and BMW together make up a little bit more than 30% of our portfolio. In their own ways, these unique and very profitable companies are valued as if their businesses could suddenly begin to wither away for no foreseeable reason. More probably, however, these companies will continue to do very well. In the cases of our other stocks, we could

present similar arguments. The conclusion would be the same. The stocks we own are generally very underpriced. In looking at their valuations, the only reasonable response that comes to our minds is to buy as much as possible and then just sit back and wait. The most difficult part of this is the "sit back and wait". I assume we can agree on that. As Warren Buffett puts it: "The stock market is a device for transferring money from the impatient to the patient." We want to be on the side of the patient ones in the end!

Invitation to a conference

In November, Lenka Schánová and I are organising the 6th annual Czech Investment Conference. As usual, you are all cordially invited!

We look forward to seeing you at the Pyramida hotel in Prague during 11–12 November!

Programme and registration here:

www.ceskainvesticnikonference.cz

Daniel Gladiš, October 2019



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