VLTAVA FUND

AN EXERCISE IN MARKET PSYCHOLOGY

Dear shareholders
In the first quarter of 2016, the Fund's NAV grew by 1.9%.

A roller coaster ride

Very interesting events played out through the first three months of 2016. Share prices headed sharply lower right from the first days of January. According to some statistics, it was the worst start to a year in several decades. Already by 20 January, that is after merely 12 trading days, US share prices had fallen by 9% and those in Europe by 12%. This provided fodder to various market commentators and forecasters, and in particular to those so-called "perma-bears" who have long had a negative outlook on the market in practically any situation. Awoken from their hibernation, they began popping up like jacks-in-the--box, and one could not open a financial newspaper or watch a financial news channel without being hit by a wave of dismal prognostications very nearly foretelling the end of the world.

There were plenty of arguments from which to construct such negative prophecies. For example: low and dangerously slowing growth in the global economy, deep recession in such countries as Russia and Brazil, complete uncertainty in China accompanied by a clueless and uncommunicative Chinese leadership, a veritable depression in the commodities sector as the number of mining company bankruptcies rose and problems worsened in countries dependent on commodities, rising yields (which means falling prices) on junk bonds, and, in contrast, extremely low interest rates as central banks continued to deform rates, and particularly those in relation to government bonds. Then, too, of course, there were the timeless old standards of unpredictable (if not entirely helpless) central banks and geopolitical risks.

To many, it was wholly obvious that prices would have to decline in such an environment. And decline they did, but just when it seemed the last ray of hope for a turnaround was fading prices unexpectedly and without warning began to rise just as rapidly as they had dropped. The turning point was around 10 February, by which time European share prices, for example, had slipped to nearly 20% below where they had been at the start of the year. By the close of March, however, the main US indices were just nudging above where they had begun the year and European indices had worked off most of their losses. Had this all been much ado about nothing? It almost appears so. Someone who had spent the first three months of the year meditating in a cave would conclude after glancing at current prices that nothing much had happened in that time and that it had essentially been a boring quarter.

Why?

Although for long-term investors like us who think in horizons of 5 years and longer these short-term price movements are truly not very important, we cannot avoid the question why? Why did prices first decline so much and then come back so strongly? We get asked this question very frequently, because it is just human nature to seek the causes of such events. In the case of share price fluctuation, the matter is not a simple one. **The actual causes of their movements cannot be determined with certainty, and prices frequently require no special reason to make large movements.** Nevertheless, we can at least speculate about their causes.

The most interesting fact about the large price movements this year was that they occurred within an environment which, while it may not be ideal for equities, is currently and essentially quite stable. The second paragraph of this letter could describe equally well the situation from last autumn, that from the turn of the year, and even the state of affairs today. Certain parameters have moderately worsened over that time, others have modestly improved, but it can essentially be said that all the risks had generally been known for a long time and recent months had brought no dramatic turning point which one could identify as an impetus to set off a large market swing. **Therefore, let us not seek explanations for this year's tumultuous share price movements in macroeconomic data but rather in market participants' shifting thinking.**

To date, this year has been a good example of how the market (and by this I mean the masses of people trading on the markets) sometimes interprets identical data in entirely different ways. Share prices were rising in autumn and then at the turn of the year – without any substantial changes in the data available to investors – those prices dropped sharply. After a time, prices moved just as abruptly upward again – and again without any substantial changes in what the data was saying. The main factor moving prices related to changes in investors' heads rather than changes in the data to which they had access. Investor psychology entirely ruled the market. Robert Shiller, my favourite contemporary economist, describes this with his "feedback theory". It is obvious that investors are not perfect machines without emotions but instead ordinary people with all their behavioural shortcomings and errors. They are subject to influences from their surroundings and the media, they feel safer when they act in accordance with the majority, and they consider price movements to be feedback confirming the correctness of their actions. All of this leads to exaggerated price movements (in both directions).

How should investors behave?

Unremitting price fluctuation is not the exception but the rule, and every investor must expect it. Properly coming to terms with this is important, but it is not simple. It is difficult to clearly formulate and remain focused on one's investment objective while at the same time controlling one's emotions. The following three rules may comprise the key to doing so successfully.

First, do not try to predict short-term price movements. To do so, it clearly would not be sufficient to predict the development of key data correctly (which is an essentially superhuman task in and of itself) but necessary accurately to predict the market's response to that data (which is more or less impossible). I have never heard of anyone able to predict short-term market movements systematically and reliably. Whoever understands this fact avoids the greatest errors.

Second, take a long view. Warren Buffett says that when someone thinks in the short term, with a horizon of 2–3 years, this cannot be called investing. Many people will be surprised that Buffet considers 3 years to be a short-term, speculative horizon, but we absolutely agree. Buffett recommends thinking in a horizon of 5 years and longer, and this is our practice as well. For such a long-term investor, short--term market movements are immaterial and most of the time can be ignored entirely. Speaking of Buffett and long-term investing, here is an interesting case in point: Last week, Buffett's company, Berkshire Hathaway, announced that its ownership stake in Wells Fargo, the largest Bank in the US, had reached 10% (USD 25 billion). Buffett had begun buying Wells Fargo's stock in 1989 – 27 years ago. At the time, he was 59 years old. I know of no one able to think with such a long view as he does. Maybe this is also why Buffett is the richest investor of all.

Third, ideally use price fluctuations to your advantage. This means that you should tend to buy when prices are declining and be more restrained when prices are climbing. Most investors do just the opposite. They sell when prices are going down because they wrongly believe that risk increases with decreasing prices and buy after prices have been rising for a long time and this has given them a false sense of security.

With the right positioning, large price fluctuations are a source of good investment opportunities. In our opinion, and although this cannot yet be categorically verified, the January drop in prices was caused in part by share sales from sovereign wealth funds (SWFs) of Persian Gulf countries. To put it mildly, low oil prices have severely stretched these countries' budgets, and they must patch up holes by selling assets. These funds are as mysterious as Jules Verne's Carpathian Castle – no one knows exactly what they own and do, but in any case they are truly large. Oil-exporting countries alone hold more than USD 4 trillion of assets in their SWFs. According to JP Morgan, this year these funds will sell shares in a volume of at least USD 75 billion (as well as more than USD 100 billion worth of bonds). All indications are that these SWFs were forced to sell at the start of the year, and this had a very negative but temporary effect in particular on share prices of banks and automotive companies. **So, what could be better for an investor than to have a counterparty selling under pressure and against its will?** We were therefore buying in the banking and automotive sectors, generally for exceptionally attractive prices. The BMW shares in our portfolio saw their price fall during the first weeks of the year by almost one-third, for example, and so the market was pricing that company in mid-February at EUR 20 billion less than it had at the start of the year. Meanwhile, it cannot be said that the prospects for the BMW's future profitability had changed in any way.

The market sometimes offers attractive opportunities where a company's price and value differ so greatly that one must ask oneself in amazement, "Am I missing something here?" There have been such cases in the market recently. We are unequivocally benefitting from price volatility and it can be said that we welcome it!

As I stated above, the main indices at the end of March are approximately where they had been at the beginning of the year. Fortunately for us, however, they had slumped considerably in the meantime. If they had stayed flat through the entire three months, we would be cool, calm and collected, but we would have profited less over the long term.

Changes in the portfolio

We sold McDonald's and Walmart.

While most share prices declined substantially in January, McDonald's stock price continued to climb and even reached its highest level of all time. The price at 25 times last year's earnings seemed to us too high, particularly in comparison with other opportunities offered on the market, and so we took advantage of this opportunity to sell. Our profit on McDonald's shares was 35%.

Just a few years ago, Walmart was a company we liked very much and I even used its historic results in my book as an example of combined stability and high returns on capital. Things change all the time, however, and as we were progressively confronted with new facts all we could do was to adjust our opinion. In its domestic market, Walmart faces a growing risk from the "non-profit" organisation known as Amazon.com as well as the not yet large but very quickly growing German threat of Aldi. The lesson Aldi and Lidl taught Tesco on the UK market remains fresh in our minds, and we realize that even a seemingly unassailable market position cannot be taken for granted forever. Having also factored in Walmart's troubles on some foreign markets, we decided to sell these shares. Our gain on Walmart was 47%.

Although we did not open any new positions in the past quarter, we were quite actively adding to our existing ones.

Daniel Gladiš, April 2016

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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