BOOM?

This is my quarterly Letter to Shareholders number 46. (Before I started writing them, which means in the first 6 years of Vltava Fund's existence, I was writing to you only annual letters.) This is a sort of continuing lifelong book to which one chapter is added each quarter. To be honest, I scarcely can recall the content of some of those letters. Others of them I remember very well, however, including the circumstances in which I wrote them.

One which sticks in my mind is letter number 42, entitled *Virus-infected markets*. I was writing it exactly 365 days ago, 1 week before the end of March 2020, at the time when the world was newly struck by the pandemic, economies were closed, we all sat locked down in our homes, and the markets were in free fall. I admit it was not easy to concentrate on writing and to formulate thoughts without letting them be influenced by strong emotions regarding both the markets as well as daily life.

I knew that with high probability it might be said that the markets were cheap, and at the end of that letter I wrote the following:

"My personal experience is shorter and begins no earlier than in 1993. I have experienced many crises. The first one was immediately in 1994, then the Mexican one in 1995, the Asian one in 1997, the Russian crisis in 1998, the dot.com crash in 2000, and so on. In my opinion, in all those 27 years there was only one time in the markets when there were more undervalued investments and in larger amounts than this year at the end of March, and that was at the beginning of 2009."

What I did not know, of course, and could not know, was that I was writing this exactly on the day when markets touched their bottom and were turning up sharply. Vltava Fund's NAV jumped over the next 365 days (23 March 2020 – 23 March 2021) almost by 90%, and this is something I could not have expected even if knowing that markets and the stocks we owned were cheap. (As I have already explained earlier, part of this growth and part of the preceding drop remained hidden to your eyes because in the last week of March 2020 our portfolio's value leapt significantly higher even before the Fund's NAV was calculated at the end of the month.) I knew that such growth in NAV is possible, but I had assigned it only low probability. It seemed much more likely to me that the markets would continue to decline for a bit more and that the subsequent recovery would be more modest. I do not ascribe much importance to returns in periods as short as 1 year, because the element of coincidence contained therein may be just too great. Moreover, the starting point was quite low in this case and therefore bound to produce a good result. I am writing about this because it provides a fine example of just how difficult it is to predict the future. Experiences lead us rather to the conclusion that our own estimates as well as the estimates of other investors regarding the future will be almost always wrong. We will not know in advance either in which direction or by how much they will differ from reality. As the past year shows, the development may be much better as well as much worse than our expectations.

Investing is concerned always and only with the future, however, and investment considerations must therefore be directed towards the future. Fully knowing that we may be very wrong, I will take a shot at outlining our view of the near future.

Economic boom?

We presume that we are approaching a period of significant global economic boom. We have not heard that word for a long time, and I am almost reluctant to say it, but I really do think that is probably what is ahead of us. I should stipulate one caveat: that is on the condition that vaccination will be able to suppress Covid in the world over the long term and permanently. It is nothing less than paradoxical that I am writing these lines while locked down at home without the possibility even to cross freely the boundaries of our municipality. Be that as it may, our country constitutes only an insignificant fraction of the global economy and has no influence either on the world's affairs or its stock markets. When we look around more broadly, signs of what lies ahead of us are visible in many places. Israel has so far come the farthest, as more than 60% of its inhabitants have received at least one dose of vaccine to date and that country will be the first to vaccinate almost its entire population. It also will be the first country from which we will draw data about the short-term and long-term effectiveness of vaccination.

In Europe, Great Britain has proceeded furthest, and in this case it is benefiting substantially from no longer being a member of the EU. It secured vaccines in a timely manner, has already vaccinated more than 45% of its population, and, while the EU is more or less still just getting started with vaccinations, Great Britain is gradually removing all Covid restrictions. The USA is just a little bit behind, and daily life there is also gradually returning to normal already. Step by step, more and more countries will follow these leaders.

Normalising everyday life will have a great impact on the behaviour of households and their consumption. A friend living in London has described to me how the mood among people improved dramatically after Boris Johnson announced at the end of February his timetable for gradually lifting the various restrictions. It is no wonder. Try yourself to imagine what you would do were it announced tomorrow that you could do everything you had done earlier and that it would be safe to do so. You would be overwhelmed by a good mood and optimism and probably start doing things that have been denied to you for the past year. Whether your preference was for this, that, or the next thing, it would always involve increased spending.

This is precisely what we expect. The gradually fading recession was unusual in that the bank deposits of citizens in many countries grew significantly during this period, often to even gigantic proportions. This was caused by large subsidies from governments in combination with limited possibilities to spend. Accumulated pent-up demand, people's unsatisfied desires, the strong psychological effect of the newly acquired freedom, and continuing enormous government budget stimuli will very probably launch a great boom in consumption. History knows similar examples from post-war years, and accordingly it is to be expected that the velocity of money will rise sharply. Accumulated excess savings will quickly flow into the economies through soaring consumption – in all parts of the world and all at the same time.

Synchronised global economy

An additional unusual feature of the current recession is the fact that it has synchronised the entire global economy. A much more typical situation is that some parts of the global economy are growing while others are declining or stagnating and the driving force of global economic growth spills over from one place to the next. Last year's pandemic, however, impacted the entire global economy at once and brought a deep recession from which almost nobody was spared. This may be quite clearly demonstrated in the demand for crude oil, which fell from 102 million barrels per day at the end of 2019 to 81 million barrels in the second quarter of 2020.

The trigger of recession was the sudden arrival of the pandemic, and the trigger of the new economic boom will be the gradual normalisation of life and opening of economies following upon successful vaccination. It is therefore likely that substantial economic growth, too, will occur in a synchronised way across most of the global economy. The question is whether the economy is ready for this and what side effects will it have.

It is altogether likely that the global economy will go in a short time from a phase of the deepest downswing since World War II that occurred last year in spring to a phase of significant overheating. We can see certain indications of that already today, such as growing commodity prices and with crude oil in the lead. Demand for crude oil could reach a new all-time high at the end of this year and should continue to grow for many years still to come. Some analysts even argue that we are at the beginning of a long commodity supercycle. The previous one had started in 1996 and peaked in 2008. After 12 years in the cycle's downward phase, a new supercycle may have started last year in spring.

Recently, we have also noticed a shortage of semiconductors, rising prices for wood, natural gas, agricultural commodities, silver, copper, and iron ore, as well as huge increases in shipping prices. We also hear more frequently that production in various sectors is unable to satisfy reviving demand, which is moreover accompanied by a need to rebuild inventories. When we add in the continuing enormous stimuli on the part of governments due to record-high budget deficits and rapidly growing money supply, we have here quite an explosive cocktail.

It is probable that the dramatic leap in consumption and overall demand will in many places exceed the possibilities and capacities of supply. The result may be that inflation in asset prices will spill over strongly into consumer inflation and that this will bring growth in interest rates at the longer end of the yield curve. As soon as people will see that prices are rising, their consumption activity will be boosted even further, and in an environment of real interest rates falling ever deeper they literally will not be willing to hold any greater amount of cash. That means we can look for what we described in the previous Letter to Shareholders entitled *Inflation*.

What will this do to stocks?

There is one fundamental problem connected to such macroeconomic considerations. Even if we were sure that the mentioned economic boom is ahead of us, we could say nothing with certainty about how the stock markets will perform. The relationship between growth in the economy and growth in stock returns is not at all straightforward. As we could see last year, stock prices may go up or down in a recession just as they may go up or down in times of economic expansion. In our current investment deliberations, therefore, we do not rely upon macro prognoses but concentrate on two other things: the profitability of individual companies and interest rate developments.

We belong to an old school of investing wherein we do not regard as a goal of doing business to disrupt something or to grow at any cost. In our opinion, the aims of doing business are to achieve profits and earn returns to capital that exceed the costs of that capital and at the same time to do all this while financing conservatively. We endeavour to choose companies for the Vltava Fund portfolio accordingly. These companies are highly profitable, well established, have attractive returns to capital, efficient assets allocation, and conservative financing. Their very current and future profitability is the driving force of their value growth.

In an economically booming environment it can be expected that their profits will continue to grow at a solid pace. This cannot automatically be taken for granted, however, because vigorous economic expansion will surely bring also growing costs, greater competition and capacities in a given sector, greater need for investments, higher prices for capital, higher taxes, and so forth. Therefore, against the optimistic macro background we are striving to employ also a micro approach and to analyse individual companies independently. Economic expansion can shuffle the deck significantly, and yesterday's market leaders may not be those of tomorrow.

Influence of interest rates

Choosing good companies is only the first step. The second is to make sure that we are not paying too much for them. This second step is all too often forgotten, but it is quite clear that a good investment at price A might be literally idiotic at price B. Valuation of companies is not a natural science able to provide objectively precise results. It is always an estimate with a great dollop of added subjectivity on top. This cannot be avoided, however.

The value of any investment is equal to the present value of its future cash flows. So says the definition. The word "present" means that future cash flows need to be discounted back to today using an appropriate discount rate. When valuing companies, we use a far higher discount rate than are current interest rates and probably also higher than most investors use. We see a certain measure of conservativism in doing so, setting a higher bar, and also a smaller necessity to rely on estimates reaching into the distant future. Especially with growth companies, I think that many investors use discount rates that are too low and in doing so take a shortcut in an effort to justify at least in part their stocks' high prices. Moreover, low interest rates nailed by central banks to zero and the discount rate for valuation of long-term risk assets are two completely different things.

Whether investors use higher or lower discount rates, interest rates always play an important role in their construction, and especially so for those rates at the longer end of the yield curve. The higher are interest rates, the higher will be discount rates, and the lower (ceteris paribus) will be the net present value of an investment. If a global economic boom truly is ahead of us, then together with rising inflation we may expect also upward pressure on interest rates. Interest rates affect asset prices like gravity. The higher the rates are, the stronger they hold asset values down to earth.

Growth in interest rates affects all assets: in addition to stocks, also bonds, real estate, gold and others. Not all of these are affected equally, however. The influence of rising interest rates on the price of a 2-year government bond, for instance, will be small. Much stronger will be the influence on a 10-year bond and far greater still on a 30-year government bond. This is caused by the fact that bonds with longer maturities have longer so-called duration, and the influence of rising rates on bond prices is stronger for bonds with longer duration. Stocks, being assets with theoretically unlimited lifetimes, also have long duration. There have been a number of studies trying to assess the duration of stocks. The estimates vary of course, but they tend to be somewhere around the level of 25 years. This is quite long, and it means that stock prices as such are very sensitive to interest rate levels.

Most affected will be those stocks with the longest duration. Those are stocks whose current or near-term free cash flows are small or even negative and it is only expected that their cash flows will grow significantly in some distant future. On the other hand, stocks producing free cash flows already today have much shorter duration for this reason and are less sensitive to rising interest rates. Our portfolio consists rather more of stocks having these characteristics, and their durations are shorter. Not even these stocks can entirely avoid the influence of rising interest rates, however. Nevertheless, there are also stocks among them that should benefit from rising interest rates. Growth in interest rates, and mainly in those rates at the longer end of the yield curve, would help banks, for instance, to push up their interest rate margins. In our portfolio, this means JP Morgan and Sberbank. It would also help insurance companies holding large portfolios of bonds within which they continuously reinvest. In our portfolio, these are Markel and Quálitas Controladora. Also, those companies having much more cash than debts (such as Samsung or Berkshire Hathaway) should continue to do well. This is true not only because rising interest rates will not bring them greater problems but also because their financial strength and stability give them vigorous ability to adjust to changing conditions. This is a quality we value a lot in individual companies and within a world that always has been and will be unpredictable.

Two opposing forces

So, in the global economic boom likely to come, there would be two fundamental opposing forces working against one other in the markets: growing profits of companies and rising inflationary pressures bringing increasing interest rates. General economic expansion will create space for profit growth among companies generally, including those in our portfolio. Profitability of companies hit a cyclical bottom last year in the second quarter, and it has been growing since that time. It is to be expected that profitability will continue to grow quite significantly. This trend should push up the values of stocks and in many cases also their prices.

Working against this appreciation in stock prices should be the expected rise in interest rates. These rates also hit their cyclical bottom a year ago, and since that time they are climbing gradually together with inflationary expectations. In their prices, stock markets often anticipate future development much earlier than is visible in economic statistics. I think this is true also this time, and the market began to reflect the phenomena described above into the price of stocks already at the beginning of September last year. In the Letter to Shareholders that I was writing at the end of September, I described how the character of the market had visibly changed at the beginning of September. Scarcely anybody noticed this initially, but in the last quarter of 2020 the change was already undisputable, and in the first quarter of this year everybody was talking about it.

I do not want to repeat something I was writing about earlier, so I will just refer you to the last two paragraphs of the previous Letter to Shareholders. It seems that a sizeable rotation among investors from overpriced and often deeply loss-making companies (stocks with long duration) into cheap and highly profitable companies (stocks with shorter duration) is picking up pace. We believe that this trend has still a very long journey ahead of it and that it is beneficial for the stocks we hold.

Changes in the portfolio

There was a slight change in Vltava Fund's portfolio in the first quarter. We sold shares of Union Pacific. It was one of three stocks we bought a year ago at the market bottom. Although from a P/E viewpoint this was one of our most expensive purchases ever, the shares worked out quite well, and, when they were more than 90% higher at the beginning of this year, we decided to take profit and put the money into stocks with more attractive valuations.

Speaking of P/E, I would like to share a couple numbers. According to our calculations, the Vltava Fund portfolio as a whole had a P/E of 12.7 at the end of March, ROE (return on equity) of 20%, and dividend yield adjusted for share buybacks of 3.7%. This all related to the financial results for the past 12 months, which means for the period covering the deepest global recession since World War II. Profits, dividends, as well as share buybacks are negatively impacted by the recession. (This is speaking of the average, of course, because profits of such companies as LabCorp and Quálitas Controladora soared during to the recession.) Low valuation cannot by itself guarantee that our shares cannot see their prices decrease. Not only can those prices go down, but they will in fact do so substantially many times in future. This is one of the few certainties that the markets give us. Rather, what I want to say by this is that, from a long-term point of view, they remain attractively priced in our eyes even on the basis of cyclically low profits and that the speculative element is represented in their prices only to a very limited extent. Based upon analysts' consensus estimates, the profits of our companies should grow by nearly 17% in the next 12 months. Not trivial either is that if we exclude banks from this consideration, for which it does not make much sense to compare cash and debt, then the companies we own have in total much more cash than debts.

Despite the considerable rise in stock markets over the past year, there are still many attractive opportunities. Human nature also is playing a bit into our hands. Investor crowds often chase popular stocks, hot IPOs, or mysterious SPACs and completely leave aside stocks they consider boring and not sexy enough. A typical example of this category is our long-term largest position in Berkshire Hathaway. Since we bought it for the first time, its price has nearly quadrupled and yet it remains just as undervalued today as it was at that time. Considering the current rate at which it is buying back its own shares and the amount of cash that Berkshire Hathaway has, my greatest wish as a shareholder is for the company's share price to remain as low as possible for as long as possible.

Daniel Gladiš, April 2021

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