



MAIN INVESTMENTS IN THE VLTAVA FUND PORTFOLIO

Most of our quarterly letters to shareholders (and this is the 52nd in the series) devote the main body of the text to topics of current interest related to investing or to events ongoing in the markets. This time, I want instead to focus on the largest positions in Vltava Fund's portfolio. Ultimately, our work is always about the selection of specific investments. We may have different expectations concerning inflation, interest rates, or economic growth, but, at the end the day, whether we buy Lockheed or Boeing, CVS or Walgreens, Berkshire or Wirecard, or maybe JPMorgan versus Citigroup or something else altogether will determine the portfolio's return (and its risk). Therefore, the vast majority of our work is devoted to seeking out individual investment opportunities and analysing them rather than to macroeconomic forecasting.

So, following is a brief overview of our eight largest investments, which together make up approximately two-thirds of the portfolio. They are presented here in alphabetical order with the percentage weight in the portfolio of each shown in parentheses.

Alimentation Couche-Tard (ATD.TO, 6.7%)

ATD is one of Canada's most interesting and successful businesses and investment stories. From a single "convenience store" in 1980, ATD has grown to where it currently has more than 14,000 stores, most of which include petrol stations. It operates primarily in Canada, the USA, and northern Europe, It is one of the best performing companies we know within the retailing sector.

In our opinion, the management of a well-functioning company must have two basic

skills. It must be able to manage the day-to-day operations of the company, but it also must be able to allocate effectively the capital that the company earns through the years. ATD excels at both. Its long-term growth is founded primarily on acquisitions. ATD has made countless of these through the course of its existence. A look at its history shows that the company has not overpaid for its acquisitions, that it not only has been able to integrate them well, but that generally they have come to function better than they had earlier, and, above all, that ATD has maintained a modest level of debt so that it has been able to take advantage of other investment opportunities as they come along.

Despite the company's size (USD 63 billion in revenues), the potential for further growth remains strong, and we look forward to seeing what management will still show us in the years to come.

Berkshire Hathaway (BRK-A, 18.9%)

Berkshire Hathaway is our oldest position. We have held it for almost 11 years, and it has been our largest position for most of that time. We have told you so much about Berkshire through the years that it is difficult not to repeat ourselves. BRK is our core investment, and I would describe our view on the company this way: If I had to invest all my money in a single stock and could not touch it at all for 5–10 years, then I would choose BRK without any hesitation. It is a conglomerate consisting of individual investments the quality of which is well above average, with efficiency in capital allocation that is far above average, having an extraordinarily strong balance sheet, and with



very low business risk. All this comes at a valuation that is significantly below the market average. BRK's earnings power, the determination of which requires a thorough understanding of its business and a good bit of manual labour, is somewhere just north of USD 50 billion a year. Therefore, the entire company, with its market capitalisation of USD 590 billion, trades at less than 12 times annual earnings. It is very realistic to expect BRK's stock price to grow at an average rate of about 10% per year over the long term. This is considerably greater than what with equal realism can be expected from the stock markets generally. Thus, we look for Berkshire's stock to continue in beating the S&P 500 index, and to do so at much lower risk than that of the index as a whole. This is an altogether distinctive company with a unique business model led by a legend who for more than a decade has been working also for us.

BMW (BMW3.DE, 6.7%)

We consider BMW to be the best managed car company. Its overall strength is founded not only upon that of its brand and intellectual property, but above all on the quality and performance of its products. As a result, BMW has traditionally achieved high margins, very high returns on capital, and it has great pricing power, which, by the way, we can see today better than ever. The semiconductor shortage is holding all carmakers' production below their capacity for the second year in a row. Demand often is outstripping supply, and the scarcity of BMW cars on the market is more than compensated by the high margins that are currently enabling BMW to make new-record profits. BMW is well diversified regionally, both on the production side (Germany, USA, Mexico, China, etc.) and on the sales side. Its main

market is China, but it also has strong positions in Europe and the USA. In addition to being a leader in manufacturing quality, BMW is also a technological leader in all types of engines.

Our only historical criticism of BMW has always concerned its overly cautious approach to using its surplus cash. Here too, however, things have changed. Even after investing in production, additional growth, technology, and research, BMW still generates an enormous amount of free cash. Although it regularly pays out a third of its profits in dividends, surplus cash has been piling up on the balance sheet and lying idle for a long time. Just to give you an idea, BMW's automotive arm has a net cash position of approximately EUR 30 billion, and billions more are added every year. The magnitude of this sum is particularly striking when compared with BMW's market capitalisation of just EUR 46 billion. This year, management finally got the ball rolling and began buying back the company's own shares. With BMW shares trading at a P/E of 4, this is the best course of action. Doing so has significant positive impact on the company's fundamental value. I believe that BMW, in its traditionally methodical and systematic approach to things, will buy its own shares regularly and over the very long term. We then have no choice but to wish that their price will remain low for as long as possible.

CVS Health (CVS, 7.2%)

CVS is a leader in the provision of healthcare services in the USA. It has three main businesses: an enormous network of pharmacies, a health insurance company, and "prescription benefit management", which is a kind of intermediary between insurance companies and pharmacies. This is the result of



large acquisitions over the past 15 years – most notably of Caremark (2007) and Aetna (2018). The markets had deemed its acquisition of health insurer Aetna too expensive (and we agree), so CVS stock then fell into disfavour for a few years. We took advantage of this in the summer of 2020 and brought the stock into our portfolio at a time when its price was pressed down still further by the coronavirus pandemic. CVS is a giant. It has revenues of USD 300 billion, making it one of the largest companies in the world. It is a relatively stable and highly profitable company with strong free cash flow. Over the past few years, CVS has focused primarily on reducing debt. This is already much lower than it had been after the Aetna acquisition, and most of the cash is now likely to go to shareholders through share buybacks or be used for smaller acquisitions to grow the company further. CVS trades at about 11 times annual earnings, which is a very appealing valuation given the expected future growth in profitability and overall modest cyclicity in its business.

JPMorgan Chase (JPM, 5.7%)

We regard JPM to be the strongest and best-managed bank in the world. It is a leader in investment banking, commercial banking, credit cards, and asset management. Its size (the largest bank in the USA, with nearly USD 4,000 billion in assets) and diversification give it a strong competitive advantage that is compounded by its cost advantages and the high costs to clients associated with switching banks. JPM's management prides itself on running the only large bank to avoid major instability over the long term. JP Morgan's quality and strength first became fully evident in 2008 under the leadership of its CEO Jamie Dimon. Not only did JP Morgan help to stabilise

the market by taking over the failing Bear Stearns in the spring of that year, but throughout the Great Financial Crisis it was the only big US bank that did not require government assistance and it was highly profitable even in the difficult year of 2008.

A well-functioning and efficient bank can be a very good long-term investment, because the interest compounding effect works well here. JPM's return on equity (ROE) is well into the double digits and this puts it in a good position to continue producing better long-term returns than does the market. JPM has been very profitable even during years when interest rates were close to zero. The current – and perhaps not temporary – return to somewhat more normal, higher interest rates should have a significantly positive impact on the bank's interest income and overall profitability.

Lockheed Martin (LMT, 6.1%)

LMT is one of the world's largest aerospace and defence companies. The war in Ukraine has reminded investors and the wider public just how important these companies are. The aerospace and defence industry in the USA is an established oligopoly. This means that a few large firms play a dominant role. While collectively they comprise an oligopoly, individually they often have monopoly positions in particular narrower segments. Their main counterparty is the US government, a key customer in what is known as a monopsonist position. This is a rather unusual situation, but one that is very advantageous for companies such as LMT.

LMT has a strong and long-term sustainable competitive advantage ensuing from the fact that its products are developed and manufactured at an extremely high level of



technology and complexity, its development and contract cycles are measured in decades, and the costs for the government to switch to alternative suppliers are high. Moreover, part of the production is classified as secret, which further takes the wind out of the sails of potential competitors. This results in a very high return on capital and admittedly a slowly but steadily growing business.

In most NATO countries, which are LMT's customers, defence outlays are based upon the size of GDP. This is currently growing very fast in nominal terms due to inflation in most countries. A number of countries have also announced significant increases in defence budgets, whether it be Germany, which aims to get to the NATO-agreed 2% of GDP, or Poland, which wants to spend more than twice as much on defence. Add to this the need for NATO countries to replenish stockpiles of weapons and ammunition provided to Ukraine for its defence, and the next few years can be expected to bring significantly higher defence spending by LMT's main customers. The company's present moderate growth should therefore gradually accelerate. LMT is a very stable and important company with high returns on capital and strong free cash flow. It is not one of the cheapest stocks in our portfolio, but we value the fact that, among other things, its business has a relatively low correlation with the main economic cycle and so LMT's shares also provide advantageous diversification to our portfolio.

Markel Corporation (MKL, 6.3%)

While it is true that Berkshire Hathaway's unique and successful business model has for decades been apparent for all to see, it is interesting that almost no one has been able to

replicate it. In fact, this should not be all that surprising, though, because, first of all, it would be very difficult to do so and, second, it would take an awfully long time. A company that is following in BRK's footsteps and has probably gone the furthest down that path is Markel. Moreover, it is not doing badly at all. From its stock market listing in 1986 to today, Markel has returns only slightly lower than has BRK and substantially more than those of the index.

MKL's business model, like BRK's, is founded upon insurance companies that produce a growing amount of cash (so-called float) which can be invested over the long term into both publicly traded stocks and private companies. Markel CEO Tom Gayner therefore talks about the three pillars upon which the company is built. The first is insurance companies. These are very profitable in their own right over the long term and also produce the aforementioned float. This has enabled MKL to build up an investment portfolio of USD 26 billion (the second pillar) as well as a portfolio of private firms through Markel Ventures (the third pillar).

Markel can be said to be some 30 years behind Berkshire Hathaway in its development. Therefore, it still has a lot of room for growth in the coming decades and it has one undeniable advantage over BRK. That is its smaller size. BRK's market capitalisation of USD 590 billion and total assets of USD 900 billion slow Berkshire's future growth. Markel, with its capitalisation of USD 15 billion, will not have this problem until long into the future.

Nikkei 225 (6.2%)

This investment differs from the others in that it is an investment in the entire broad index of Japanese stocks. Why do we hold the Japanese



index? In the Fund's earlier years, we had invested in specific individual Japanese companies on several occasions. We have always found the Japanese market to be very interesting and attractive. It is a rather specific market, however, and to invest successfully in Japan requires a lot of work. Here, unfortunately, we have run up against our capacity constraints. We spend almost all our time and effort on the Western markets, which are the main ones for us, and we simply do not have enough time for the Japanese market. Therefore, we were faced with the choice either to stay away from the Japanese market altogether, thus missing out on an attractive investment opportunity, or to invest in it through an index, which requires much less work. In the end, we chose the latter of these. The Nikkei 225 index has been in Vltava Fund's portfolio ever since and thus far we are very satisfied with the results.

The Japanese market is the second largest after the US market, is much less expensive, has had strong profitability growth in recent years, and has been somewhat on the sidelines of mainstream investor interest. This is a pity, because over the past two decades and without a hint of fanfare, quietly, and while not drawing the interest of the wider investing public a process has taken place among Japanese companies that is a kind of strategic redirection towards what is sometimes called "aggregate niche strategy". Many companies have found their relatively narrow, and at times perhaps seemingly inconspicuous, market segments and have built strong, often leading global positions within them. In the aggregate, then, this is completely changing the nature of the Japanese market. At the same time as this strategic refocusing is going on, a certain organisational renewal also is taking

place in Japanese firms. Traditional attitudes and values, such as lifetime employment, hierarchies based upon seniority, the status of women, and so forth, are gradually being reassessed, and firms are becoming more flexible, innovative, and efficient. We like the Japanese stock market a lot. It is one of the cheapest among the major markets and will probably remain in our portfolio for a long time to come.

Portfolio as a whole and changes in the portfolio

In addition to the eight large investments discussed above, Vltava Fund's portfolio also includes another 13 smaller investments. In total, therefore, there are 21 equity positions. There was one significant change among them in the past quarter. We sold off the rest of our Samsung shares. Samsung's share of our entire portfolio has been gradually declining since the beginning of last year. While the company has been delivering strong earnings as we expected, the need for capital investment over the long term has been, and will likely remain, higher than we anticipated. As a result, free cash flow, a key valuation metric for us, is lower than we expected. For this reason, and also taking into account how many other more attractive opportunities the markets offer today, we sold the shares. Our gain was approximately 45%.

According to our own estimates and calculations, the entire portfolio is trading at approximately 10.7 times the average earnings of the past 3 years, 8.9 times the earnings of the last 12 months, and 8.5 times the expected earnings of the next 12 months. This is a very inexpensive valuation, even despite the modestly elevated interest rates. Seventeen



companies in our portfolio are taking advantage of low stock prices to make significant purchases of their own shares. For some of our stocks, the sum of annual dividends and treasury stock buybacks exceeds 10% of their market capitalisations.

Current events in the markets and in the world often lure investors to give to these most of their attention. This often leads to people's overestimating the importance of such matters and reacting in ways that have negative impacts on the value of their investments. We therefore endeavour to look far beyond the horizon of current events and take a truly long-term view in our thinking. Here is an example of what these considerations look like in a specific case:

We bought our oldest and largest investment, Berkshire Hathaway, almost 11 years ago. Back then, the stock cost USD 115,000 per share. At the time, we had estimated the stock's intrinsic value at USD 170,000. So, we were buying the shares at about two-thirds of their value, which we thought to be very attractive given the low risk and long-term growth potential. Today, we estimate the intrinsic value of a BRK share at USD 535,000. At the current share price of USD

406,000, this means the stock is trading at about three-quarters of its value. The shares remain undervalued more or less to the same extent as they were 11 years earlier, but their intrinsic value has more than tripled in that time and that rise in value has gradually pulled up the share price.

These and other figures confirm this to be a great business. To put this in perspective, over the time that we have held Berkshire's stock, profits for companies in the S&P 500 have risen by 119%. The book value of BRK, a quite reliable indicator of the company's growth, has risen by 212% – nearly twice as much as has the broader market. By our calculations, BRK's earnings power grew by 175% over the same period.

We expect a similar overall trend across the next 11 years. The intrinsic value could triple again (currently growing at a rate of approximately \$150 per day), and the long-term share price development should advance correspondingly. We can say this even as we are aware that the next 11 years are likely to bring at least as many unexpected events and twists and turns in life as have the past 11 years.

Daniel Gladiš, October 2022

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