THE YEAR 2023, THE STATE OF THE MARKETS, AND WHERE WE WILL LOOK FOR INVESTMENTS IN 2024

The year 2023 was a very good one for our investments, but I will not expound here upon how much our stocks went up last year. You already know our portfolio well and most of you follow the stocks we hold. Rather, I want to focus on describing the more significant developments within the companies we collectively own. We consider this to be more interesting and important than are short-term (for example, annual) stock price movements, as, from a long-term view, these play the main roles in the fundamental value of our investments. Following, in alphabetical order by company, are a few examples from the past year of significant events in companies within Vltava Fund's portfolio.

Alimentation Couche-Tard has written one of Canada's most remarkable and successful business stories in recent decades. Its rapid long-term growth is founded on a series of rational and well-managed acquisitions. There have been at least 20 of these acquisitions of varying size over the past decade alone, and each time we have been delighted with the acquisition target, the price and, not least, the company's ability to integrate the acquisitions well. While growth through acquisitions often looks easy on paper, very few companies can pull it off well in practice. Alimentation Couche-Tard is at the top of the game in this regard. Through the past year, the company has made several acquisitions. The largest of these was its purchase of some 2,200 retail sites from the French company TotalEnergies located in Germany and the Benelux. The purchase price of €3.1 billion looks to us very good, and this is very likely to be another bead on the chain of successful and value-creating acquisitions. It should bring significantly higher profit and free cash flow while not overburdening ATD with debt. We estimate that ATD currently has sufficient debt capacity to make up to $10 billion in additional acquisitions. We look forward to seeing them. What is remarkable about the whole situation is that, even though ATD has been growing over the long term primarily through acquisitions, the company's debt remains relatively small, and it still managed over the past few years to buy back nearly 20% of its own shares.

Viewed from a distance, as it were, **Asbury Auto** resembles ATD. Although it is in a different industry, Asbury Auto also is a retail business and a company that has been growing very successfully through acquisitions over a long time. The most recent of these was last year's purchase of Jim Koons. To put that into perspective, this means that one of America's largest and best auto dealers is buying another big and successful auto dealer. Jim Koons is an established and highly respected company among auto sellers. It has sales of just over $3 billion, and it is about one-fifth the size of Asbury Auto. The long-term growth of Asbury Auto is almost unbelievable. Judge for yourselves. In 2011, earnings per share were $1.43. For 2023, this figure will be approximately $33. That is 23 times the 2011 level. This earnings growth rate is of course not sustainable as the company continues to expand, but we nevertheless believe it will remain well above average for quite some time

to come. The acquisition of Jim Koons should provide a perceptible boost.

Entire books have been published on **Berkshire Hathaway** transactions. One of the best that I can highly recommend is Adam Mead's 2021 book, *The Complete Financial History of Berkshire Hathaway*. The book is excellent and detailed, but it, too, will need updating over time. In fact, Berkshire Hathaway writes another interesting chapter in its history every year. A chapter describing 2023 would be quite extensive. At the turn of the year, Berkshire completed its $11.6 billion acquisition of the insurer Alleghany Corporation. A little later, Berkshire increased its stake in Pilot Flying J to 80% and its holdings in five Japanese "*sogo shosha*" conglomerates to 8.5% (a total investment at current prices of about $20 billion). Through the course of the year, Berkshire also steadily increased its stake in Occidental Petroleum to 37% (including warrants). Berkshire Hathaway continues to be a very unique type of conglomerate whose investments generate huge amounts of cash and which can successfully reinvest that cash again and again over the long term. It is an almost perfect case of a snowball in the markets. Here is one interesting fact: we estimate that the intrinsic value of a single Berkshire share is currently growing at a rate of about $178 per day. When we bought the shares 12 years ago, this was less than $50 a day. The rate of growth is accelerating gradually and with minimal fluctuations. Moreover, Berkshire has additional decades of similar growth still ahead of it.

Burford Capital is one of the most interesting and difficult to replicate businesses we have come across in recent years. Burford is a "litigation finance company", meaning that it finances its clients (primarily large corporations and law firms) through litigation in exchange for a share of the awarded damages. It is essentially an investment company whose portfolio consists of individual litigation cases. The long-term historical returns are very high (Burford on average earns close to 100% return on funded litigation) and Burford can repeatedly reinvest the funds from profits without the average return declining. Such companies are very rare. In Burford's broad portfolio of about $7 billion in total, a case involving the expropriation of YPF shareholders by the Argentine government stands out in size. This litigation made significant progress last year and the court has even already determined the damages to be paid by Argentina. Initial estimates were in the range of $6–16 billion. In valuing Burford's shares, we had been working with an amount at the low end of that range and so we were pleasantly surprised when the court set the damages at the high end. Of the established $16 billion (and this amount grows by an additional $2.3 million per day due to penalty interest), about $6.2 billion should go directly to Burford. That is a relatively large sum of money compared to Burford's market capitalization, which, despite an 83% rise in its stock price last year, is about $3.4 billion and includes all of the company's other extensive businesses. We do not expect that Burford will receive the full $6 billion. We anticipate a settlement agreement with Argentina and a lower figure. On the other hand, we think there are other cases in Burford's portfolio that have potential to generate billions of dollars in damages and, moreover, where the counterparties are of a different calibre in terms of creditworthiness and enforceability than is Argentina. Burford is a company that is trickier to analyse, requires

more abstract thinking, and also has an irregular and difficult to predict cadence of financial results. But that does not bother us in the least. Quite the contrary.

Last spring, the US went through a brief banking crisis that cost several smaller and medium-sized banks their lives. One of them, First Republic Bank, with assets of $230 billion, went into receivership and was bought out by the largest US bank, **JP Morgan**. The acquisition terms were very favourable for JPM and the facts that few, if any, other banks could have taken over the whole of First Republic Bank in its then-present state while guaranteeing more than $100 billion of its deposits played a role. JPM could do it. It is not only the largest, but also by its balance sheet the strongest US bank and, in our opinion, clearly the best managed. It has come out of this crisis even stronger. We have actively followed the banking sector for 20 years in many countries around the world. Our view is that a well-managed bank can be a very good long-term investment but that it is better to focus on the best and highest quality available. Banking is not a sector where it pays to trade quality for cheaper valuations. That is why we hold JPM.

Value can be created in various ways. Acquisition is one possibility. So-called spin-offs represent another. This involves hiving off a part of a company into a separate entity and taking it to market. One such spin-off occurred last summer with **LabCorp**. It spun off a smaller part of the company under the name Fortrea. For each of their shares, LabCorp shareholders received one share of the new Fortrea. It started trading at a fairly attractive price, so we sold immediately. Considering the price we got, we could say that this spin-off brought us some value, but it was only a one-off transaction and not a very large one at that.

Also noteworthy are developments in the Japanese market. We have held the **Nikkei 225** index as one of our top 10 positions since 2017. We made this investment in response to changes we had previously observed in Japan. The Japanese corporate world has been quietly shifting to something termed an “aggregate niche strategy.” At the same time, there have been significant structural changes within companies in Japan. These we consider to be crucial. Japanese equities are not a bet on the macro or some other economic trends but on deep structural changes in corporate management that deliver much higher margins and returns on capital. Everyone talks about US equities, but few seem to notice that over the past 11 years the return on Japanese equities has been higher than that of US equities, and above all that Japanese companies’ profits have grown much faster over that time (nearly tripling while those in the US have only doubled). In real terms (i.e. after accounting for inflation), earnings growth looks even more strongly in Japan’s favour. We believe that structural reforms in Japan will continue and that their impact is far from being fully realised. We are glad that we can benefit from them together. I will not hide the fact that we are also pleased about Buffett’s investments in Japan and his promotional visit to Japan early last year. We see that a bit as validation of our views.

Not every transaction creates value. Some transactions destroy company value. An example of such transaction is **CVS**’s acquisition of Oak Street Health in early 2023. This acquisition cost CVS $10.6 billion, and, based on metrics cited by the company itself, it

seems to us that it was a waste of money for the most part. Unfortunately, CVS has its own history of overpriced acquisitions. The last one prior to that was in 2018, when CVS bought health insurer Aetna for $69 billion. We had assumed that CVS management, which has since changed, would recognise that mistake and learn from it. We were wrong. The acquisition of Oak Street Health is both disappointing and a warning to us. We now have a company in our portfolio whose capital allocation we consider to be poor and that should not be there. Unfortunately, the situation is complicated by the fact that the CVS stock is now very cheap and therefore we are reluctant to dispose of it just yet. We probably will do so, however, when the opportunity arises.

We could continue with other companies in our portfolio, but these are probably the weightiest examples. All the companies we own are consistently and highly profitable. They pay us a portion of their profits on an ongoing basis through dividends and share repurchases. They reinvest the remainder in the business itself and in its continued growth. The capital they have invested in their businesses is therefore gradually increasing, and, if they can keep the return on capital high, we can expect profits and free cash flow to grow at the same rate. We view every company as a living organism where people create value through their work. The results of that human labour, combined with the capital available to companies and together with its efficient allocation, then create wealth for shareholder-owners. Therefore, our first priority always is to see how the story of each company unfolds, what changes are taking place, and how the business is being built over the long term. If we are satisfied in those respects, then we know that the share price will reflect this over time. This is one of the few things in investing that we can rely on.

Changes to the portfolio

There was no significant change to Vltava Fund's portfolio in the last quarter. There had been no need to intervene. We were pleased with its composition and with the development of events in individual companies and their share prices. With a view to current prices, however, we plan to narrow the portfolio a bit in the new year and drop one or two companies that have below-average potential compared to our other investments. Consequently, the weight of other, more attractive opportunities in the portfolio will increase a little.

What should we say about current events in the stock markets? Although global stock markets had fallen sharply in 2022, our portfolio's return was much better. I must say that we expected this because our portfolio is more conservative and less risky than is the market portfolio. We are even much more pleased that our return was significantly better than the markets' return even in 2023, when stocks were up significantly overall, even with no major changes to our portfolio and the same cautious approach to risk. Despite that it is still taught in universities – and many theorists and academics believe – that higher returns require taking on greater risk, our portfolio shows that returns higher than the stock market average can be achieved with much less risk – in both rising and falling markets. This is very important just now. A significant dichotomy in market movements and stock valuations has reigned for some time and this has risen to new extremes in the past year.

What are we talking about? The performance of US and global indices is now driven by a handful of the largest US stocks. The ten largest U.S. stocks today account for about 30% of the U.S. market and some 18% of the global stock market. Their market capitalisation is equal to that of Japan, the UK, China, France and Canada put together. According to Goldman Sachs, the typical hedge fund has about 70% of its portfolio in these titles. All of this combined with the boom in passive investing represents the largest concentration of large-capitalisation stocks in history. We look elsewhere for our investments, and for two reasons. First, we do not find any of the largest stocks sufficiently attractive to have a place in our portfolio. As a whole, they are expensive, and some of them are extremely expensive. Second, history shows that whenever the concentration of the largest stocks has been high, it has paid to deviate from the index. Today, the concentration of large stocks is at an all-time high.

Logically, if a handful of the largest stocks are driving the index and are more expensive than average, then the other stocks as a whole are doing worse but are significantly cheaper. This is precisely the state of today's markets. The concentration of investor interest and money flows, reflecting, among other things, a situation where most of the money (at least in the largest, US market) is invested passively in indices, which means automatically, without anyone thinking about what they are buying or how much they are paying for it, is leaving the stocks of many high-quality, established, highly profitable, fast-growing, and well-managed companies lying on the sidelines. That is where we have been directing our interest for a long time. We select investments in the spirit of the saying "Eagles may soar, but weasels don´t get sucked into jet engines." There are plenty of opportunities. Where are we looking, for example? Among companies with medium and smaller market capitalisations, among companies that have irregular profitability trends, among companies where the share price influences the narrative, among companies that are cyclical, among companies where the market does not appreciate the secularity of the trend, among companies making significant positive leaps, in sectors that are unfairly maligned, in countries whose markets are statistically cheap, and so on.

There is always something to do, always something to look for. We are keen on keeping various statistics, and that is why we know that we have analysed 2,150 different companies from 62 countries through the Fund's history. The vast majority of these are not sufficiently attractive businesses and there is no need to go back to them. Some of them are very interesting, though, and we continue to analyse those on an ongoing basis. In addition, there exists a vast number of companies that are still unknown to us. We are gradually working on them and from time to time we come across something that we can add to our "shopping list" of stocks. This is a shortlist of companies from which we directly select stocks for the portfolio. We presently have about 50 entries on that list.

Our portfolio is currently valued at a very low P/E of 9.3×. This is even lower than it was at the start of 2023, despite last year's share price rise, and by this metric the portfolio is cheaper now than it was a year ago. All of this is on top of an average return on equity (ROE) of 26% and the fact that most companies in the portfolio are growth stocks. At this valuation, the speculative component of the portfolio is

much smaller than if it were composed of the so-called “magnificent seven” (Apple, Alphabet, Amazon, Microsoft, Nvidia, Meta, and Tesla) and has a higher expected return.

Let me conclude once more by thanking you. The number of Vltava Fund’s investors and the amount of its assets are at historic highs and we have investors from seven countries. Although the size of the Fund is neither now nor ever has been our priority, we are very pleased with this development and see it as an expression of your confidence in our common investment future. We are humbly grateful for that sign of faith you have shown in us and in our work. We thank you and we wish you a happy New Year.

Daniel Gladiš, January 2024

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