
Selected Insights and Ideas by Daniel Gladiš

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Daniel Gladis presented his in-depth investment thesis on BMW (Germany: BMW) at European Investing Summit 2017.

BMW is a readily understandable business with a moat, managed in the interest of shareholders and attractively priced. It consists of two complementary businesses: automotive and financial services. The company sold 2.36 million cars and 145,000 motorcycle in 2016, up 72% and 45%, respectively, compared to 2006. Net income, EPS, and book value per share have grown more strongly over the same period, increasing by 140%, 139%, and 147%, respectively. Meanwhile, the price of the common and preferred stocks rose by 104% and 67%, respectively, from 2006-2016. Strong returns on capital and brand value reflect the moat of the business. On the ownership side, majority ownership of BMW has remained stable for a century. The company has done no overpriced acquisitions, taken no large asset write-downs, displayed no excess in terms of management compensation, and capital allocation has been good. Business risks include “peak auto”, BMW bank, electrification, autonomous driving, and interconnectivity.

Daniel’s sum-of-the-parts valuation suggests that the vehicle production business recently traded at 3.3x earnings and 48% of book value. Daniel bases this conclusion on a value estimate of €27.30 per share for the BMW bank business (€18 billion total value, or 1.6x book value, justified by an ROE of 18%) and €18.20 per share (€12 billion) of excess cash in the automotive segment. Subtracting the combined value of €45.50 per share from the recent equity quotation suggest a market value of €28.50 per share for vehicles production. Another way to look at the sum-of-the-parts valuation considers brand value of €30 billion, which may be added to automotive book value of €37 billion to imply automotive value of €67 billion. However, valuing the automotive business at 8x earnings suggests a value of €44 billion. As a result, Daniel puts the fair value of the auto business at roughly €55 billion. When added to the value of BMW bank and excess cash, the combined intrinsic value of the equity may be €85 billion, or €129 per share.

The following transcript has been edited for space and clarity.

My idea is BMW and its preferred shares. BMW is a long-standing European value stock, but perhaps it is time to revisit the idea. Looking at the state of the market — disruptors, visionary leaders in combination with ETF mania — favors glamour and suppresses everything that can be described as a boring, traditional, and profitable. This leads to the conclusion that traditional measures like quality and the ability to make large profits on a regular basis are underappreciated. BMW is a typical example of such an underappreciated stock. It is a readily understandable business owned by a family and managed in the interest of all shareholders, and it is attractively priced. There are four statements [in this sentence]:

First, “understandable business”: It is a combination of two complementary businesses. They are automotive and financial services. The automotive business produces BMW, Mini, Rolls-Royce cars and BMW motorcycles. They design, develop, brand and market their automobiles. They produce over two million cars per year and about 145,000 motorcycles. The other part of the business is financial services. It provides credit financing and leasing

of the BMW brand cars and motorcycles to retail customers. They also provide financing for the fleet business and support to the dealership organization, mainly by financing the dealership vehicle inventories. These two businesses are different, but they complement each other nicely. The financing business, "BMW bank" finances approximately half of all purchases of BMW vehicles and it produces about 20% of the company's profit.

Over the last decade, BMW's car production is up by 72%. Revenues are up 92%, the contract portfolio (the number of leasing and financing contracts in financial services) is up 125%. Also, in terms of profitability, we have a net profit and EPS of 140% each, book value of 147%. The stock price is lagging, It is only up 104% in common, while preferred shares are only up by 67%. Net profit, EPS, and book value went up by the same percentage over the past ten years. The company is managed in a steady fashion. It does not need new equity, does not do over the priced acquisition, there is no dilution. There is low volatility in return on equity, so the book value, net profit and EPS grow at the same rate over time.

Does the company have a moat? We look at two things, return on capital and brand value. The 2016 Forbes list of the most valuable global brands shows BMW as the most valuable European brand and fourteenth in the world, with estimated value of €30 billion. It is one thing to say the brand has value; if a company has a moat, it must be visible in their financials. The best way to judge this is to look at the returns on capital. The automotive business in 2016 achieved a return on capital (ROC) employed of 74% which is an extremely high number. The bank return on equity (ROE), the financial services our return on equity was 21.2%, which for banking business is also high. The company targets a long run a 26% return on capital employed for the automotive business and an 18% return on equity for the banking business. The combined ROE for the whole company has been about 14% for the last ten years on average and about 17% for the past five years. The ROE for the bank is lower than that of the automotive business because it is affected by a large net cash position in the automotive business which stands at €22 billion.

If we strip out net cash and figure out the return on equity for the automotive business, we arrive at an ROE figure of over 20%. This is because the equity at the end of last year for the automotive business was about 36 billion with an excess cash of about 20 billion at the end of last year. If the company needs 10 billion cash to run the business safely, there must be at least 10 billion excess cash present on the balance sheet of the automotive segment, taking this away leaves an equity of about 26 billion and the net profit for the auto business last year was 5.4 billion, so that gives you ROE over 20%. An auto segment of a business with ROE of 20% or above and ROC employed which is higher and a banking side with ROE over 20%. This suggests there is a moat because this is higher than typical companies.

Is the company managed in the interest of shareholders? BMW was founded a hundred years ago and was purchased by the Quandt family about fifty years ago. The Quandt family owns about 46% of the business. Although it does not manage the company directly, it supervises management. Historically, the company has not engaged in overpriced or megalomaniac acquisitions. There are no large write-downs of assets, nor excessive management compensation. There is a high-quality culture, different from companies like Volkswagen.

You see a good capital allocation. Perhaps the company has too much net cash — €22 billion — and this reduces the efficiency of the capital allocation. On the other hand, what would companies like Tesla give to be drowning in cash? So, this is a minor problem.

With regards to acquisitions, they acquired Rover Group in 1994, a UK company that manufactured Land Rover, Mini and MG but was in a difficult financial position. Six years later they sold the Land Rover brand to Ford, and they kept the mini. From 1998 to 2002 they acquired Rolls Royce. That was it. Judging by the subsequent returns on this business, their capital allocation is good. For long-term shareholders, this is one of the most critical factors.

The company is managed methodically and carefully, in a true German fashion. The annual report has kept the same format for the last ten years — the same chapters, the same organization. The company is being organized in a methodical, systematic way.

Revenues have more than doubled over the period. Net profit is up by more than three times. In 2008 and 2009 the company had low profitability in the middle of the financial crisis, but it was still profitable, unlike other car companies, which in many cases showed large losses or even faced bankruptcy. As soon as the crisis ended, BMW resumed its previous trend. The same applies to EPS, which is also up more than three times over the period. Book value is up more than three times and ROE, with the exception of the two crisis years, is steady between 15-20%.

The stock is underpriced, and the recent price offers a large margin of safety. I value the company using two simple valuation approaches: (i) sum of the parts and (ii) the return-on-equity model.

Sum-of-the-parts valuation: BMW Bank achieved ROE of 21.2% [in 2016] and typically achieves ROE above 18%, which is high for a bank. Normal banks would kill to have ROE of 18%. Large banks in America have average ROE of ~9%, British banks just over 5%, European banks 7%, and Japanese bank 6.5%. For all these banks to have ROE of 18% is just a dream. Moreover, BMW Bank is a bank with low risk. The risk of bad loans is low because most of their debtors are BMW drivers, a group with above-average credit quality. In 2016, the bad debt ratio was 0.3 — only 1 in 300 loans is not repaid. The credit risk for normal banks is typically higher. If BMW Bank was an independent bank, it should trade at a multiple of book value 1.6-2.2x. Even at 1.6x book value and assuming only 18% ROE (their long-term target, lower than the last several years), you arrive at a valuation for the bank of €18 billion or €27.3 per share.

The automotive business has net cash of €22 billion, of which at least €12 billion can be considered excess cash. That leaves €18-18.2 per share.

If you put these two figures together, you arrive at €45.5 per share. The preferred share is €74, implying that for the automotive business you pay €28.5, which is exactly 3.3x earnings and only about 48% of book value. I don't know what the market value of the automotive business is exactly, but it is a lot higher than 3x earnings and not less than the book value.

The brand value estimate from Forbes is €30 billion. Putting together the brand and the accounting book value, you arrive at €67 billion. Automotive earnings multiplied by a P/E of 8x equals €44 billion. The midpoint of €44 billion and €67 billion is €55 billion, which could roughly be the value of the automotive business. Adding together the value of the bank, the cash, and the automotive business gives €85 billion, or €129 per share, compared to the recent price of €74-75 per share.

My alternative valuation is based on the ROE model. With the exception of the financial crisis, BMW is able to operate with above-average and steady ROE. The EPS for this year is expected to be €11.9, while the book value at the end of 2017 will be about €8 per share. Assuming the company averages ROE for the next three years of 13%, which is below their 5-10-year average. If the ROE is 30% for the next three years, then the EPS in 2020 could be about €12.9. But excess cash at that time would be about €20 billion because the company even after paying high dividend still keeps adding between 2 to 3 billion per year though its net cash. At the end of 2020, we would have excess cash of 20 billion at least, which is over €30 per share. Also, you would collect cumulative dividends after tax of €13.4 per share. If you put these three things together, you arrive at €159 per share using the ROE model, more than twice as high as the recent stock price.

The previous analysis concludes that at the recent price we implicitly pay €28 per share for the automotive business, or about €18 billion. If someone came and said, "Here is €18 billion, go and build a company equal to BMW", it could not be done. For €18 billion you would be unable to build the factories necessary to assemble the cars, develop the models, build the marketing and distribution network, and the reputation and brand value, to achieve margins and returns on capital at the top of the industry and still have about €10 billion of extra net cash. Our rough estimate is that not even €60 billion would be sufficient to do that.

The market is offering us a top-class, financially strong, family-owned business at half of its value. How is this possible? It is difficult to say but investors or the market must either believe there is a hard recession just ahead, after which there will be no recovery, or Tesla will dominate the future and current car manufacturers will be marginalized. None of this will happen. BMW will probably end up with an even stronger position in the future.

The business does have risks. The first relates to the current business. We might be at a "peak auto" moment, meaning car sales may be peaking and may start declining. I don't think we are [at such a moment]. BMW has three large markets: Europe, China, and the US. Each market is in a different face of the cycle. In the US we are at a plateau of roughly 17 million cars sold per year, which is about the same as the amount of cars sold between 1998 and 2007. At that time the plateau was at the same level for nearly ten years, so we are at the same position. We might be there for another ten years. They might go down from there or go higher because the population in the United States is higher, we don't know, but most important is the other markets are not plateauing.

China is the biggest market in the world, where about 28 million cars would be sold this year, about 50% bigger than US and the market is still growing. It has re-accelerated a bit after a large slowdown in 2015 and the growth this year would be about 4%, which you

know in China means about two million cars more than last year. The European market which is about the same size as the US market, about 17 million cars per year is growing at about 2% this year maybe another 2% next year, so we might be at the peak auto in US, but I don't think we are at a peak auto globally as yet. The risk would be if we would be paying peak multiples for peak earnings, although we might be close to peak earnings we are not paying peak multiples for BMW. In fact, we are paying below-average multiples.

BMW Bank has different risks. It is a large business: last year they finance more than 1.8 million contracts which is nearly half of their sales. The portfolio is over five million contracts. The balance sheet of the BMW Bank is about €100 billion. It is financed partially by its own capital, and partially by deposits which amount to about €14 billion and then by wholesale financing. The risk from this business is risk of credit default. Going back to 2008 and 2009 bad debt ratio was low. You may recall 2008 and 2009 were years of a tough recession and tough credit conditions and also a huge decline in car production and sales all around the world. It was the worst year for BMW in terms of bad loans ratio, the ratio was 0.84, so less than 1 in 100 loans were not repaid and pre-tax loss or the financing raised at that time was €292 million. The real stress test for the bank was ten years ago, showing the credit quality of the BMW Bank is quite high. Today the business is larger than it was before, but it has grown with the company itself.

The company is more than twice as large as ten years ago. Sales, profitability, book value, capital and also the financing business is about double, but there is no increase in leverage. On the contrary, BMW did not have a large net cash position ten years ago, and now they have twenty two billion. The average maturity of a loan is about two years, so it is a simple business that provides financing for purchases of their products and financing of a dealer inventory. Their credit quality is high, because the lending is to BMW drivers.

Other risks relate to the development of the car industry. There are three trends that can clearly be identified in the auto sector. One is a move to electric vehicles, the other is the move towards autonomous driving, and then the third one is connectivity and perhaps also a shared mobility. The evidence supports the view BMW is at the top of the race in all of these three segments. They are among the top cars in the electrification move. They are advanced in autonomous driving and also in connectivity and shared mobility. BMW has created a "dream team" to develop autonomous vehicles. In 2016 they partnered with Intel and Mobile Eye to deploy a joint partnership model in autonomous vehicles in order to provide an adopt solution to all car makers. Five months ago, Delphi joined the Alliance to provide expertise in electronic components. In 2015, BMW together with Daimler Volkswagen and Intel bought a cartographic company called HERE, which was formerly owned by Nokia and is specialized in the auto industry and that enables them to compete directly with Google and Apple. Therefore, we have a dream team that combines BMW, a premium car maker with expertise in car production and fully integrated systems, Intel which produces semis and chips and has the expertise and the brain of the vehicle, Mobile Eye which specializes in vision systems and mapping and has an expertise in cameras and chips and can be the eye of the car.

Finally, Delphi which specializes in sensors and platforms and has an expertise in radars

and lidar systems and a company called Here which does mapping. This alliance positions BMW well in the race towards autonomous driving. We are somewhere between the second and third level autonomy development. BMW has second level “hands off” semi automation driving in their cars. They are trying to implement in selected cases the third level called “eyes off” the high automation systems. They claim by 2020 they will be ready to move to level five, which is fully autonomous.

In terms of electrification, BMW is far. It occupies the spot number three in the world in terms of the number of electric vehicles sold. The number one is Nissan, number two is Tesla, and the number three is BMW. The only reason why BMW, as well as some other car makers, are not further ahead today is the whole segment is still small and it is loss-making for everybody. Consequently, the question is does it make sense to be the leader today, if you are going to be losing more money by being bigger, and, how ready are you to step up on the gas when the market gets big enough.

In summary, BMW is a high-quality company, and it is hard to argue their products are anything less than high quality. I remember living in a communist country, and when I was younger about 30 years ago, all people aspired to drive BMW cars. It is the same today, and it would be the same in 20 years. This shows the durability of the brand. What is overlooked is the value of the BMW Bank which is a profitable part of the business. It makes about one-fifth of the whole company profit, and it complements the car production business neatly. It is well-managed in the interest of shareholders and supervised by the Quandt family. It is well-prepared for the future and all these traits at a price which can hardly be justified as fair. You cannot build this business for the amount you can buy it on the market, and the beauty of the stock market is you don't have to build such a business from scratch but you can buy it.

There are two stock issues — the common stock and the preferred share. The common is larger, more liquid and voting power, while the preferred share is less liquid does not have voting power and has a slightly higher dividend. But it usually trades at a discount to common. Sometimes the discount is zero as was the case in 2006 or so, other times the discount can be as high as 25%. Today we are talking about something like 50%. In theory, the value of any investment depends on the future cash flows, and you are buying the same cash flows by buying either common or preferred share but the preferred share allows you to buy it at 50% discount. For a long-term investor, this is a better play, and we have also been happy owners of the stock for a number of years.

The following are excerpts of the Q&A session with Daniel Gladis:

Q: With regard to the Tesla impact, Tesla does have good access to financing and is gaining market share, it also targets customers in a similar demographic to BMW. What is your take on Tesla continuing to gain market share and perhaps impacting units at the high-end car makers, especially in light of the fact this is a high fixed-cost business and volumes are important?

A: I was considering suggesting to finance the long position in BMW by shorting Tesla, but then I saw I would have to present two cases so I stuck with one. My view on Tesla is

negative, it is true they seem to have a large market share in electric vehicles but remember electric vehicles represent about 1% in all car sales today and they have about 10% market share in that. Their market share in car production is about 1/10 of 1%. It will be a lot bigger in the future, but they had a great advantage of being the first, despite that they were still not able to make any money and I am not convinced Tesla is close to start making money. There is a big difference between designing a great car and being able to profitably produce it in large amounts.

Tesla will face tougher competition. The only reason why the other car companies have not competed hard enough so far is the electric vehicle business is loss-making for everyone, so, you can try to be first but you would be losing more money for longer than if you played it safer. The evidence shows the other companies — Daimler, BMW, Toyota, Volvo, GM — are starting to push ahead. They have more resources than Tesla and it would be extremely difficult for Tesla to keep any technological advantage in the long run. They might have some today, although it is smaller than the market perceives, but to keep it in the long run would be difficult. As they still keep losing money, they are dependent on their shareholders for further financing, and if there is a recession, if there is peak auto, if there is a market correction: a change in the hearts of their supporters they will struggle. The other companies will not struggle. They can keep moving ahead with their electric vehicles business plans regardless.

I read a paper about some of the European car makers and the four of them BMW, Volkswagen, Renault and Peugeot. They expected to invest \$125 billion in R&D over the next four or five years. Only some portion of that amount would go to electric vehicles but the amount of resource these companies have is bigger than Tesla. Tesla would have a problem to win this race. I wish them luck because I want everyone to succeed, but the odds are against them, because many investors may not realize Tesla is not a technology company, not a software company it is a car company. You need a lot of fixed assets first to be able to produce cars in mass amounts and to be able to logistically master that so you can have high margins is difficult. BMW is at the peak of margins. They have the highest margins with the exception of Ferrari and Maserati, which is a different story. But it is difficult to achieve high profit margins and high returns on capital. They have a hundred years of experience of doing that. It would be tough for Tesla to beat all of them.

There is another risk people don't consider, a scenario in which the future is not with electric cars. You could argue electric vehicles pollute the environment more than petrol vehicles, because we have to take into account the whole cycle. You have to mine a lot of metals, and mining highly pollutes the environment. You have to produce the cars, and producing electric vehicles creates more carbon than does producing petrol vehicles. When you plug in an electric car, on the other end of the network needs to be a power station that produces the electricity.

If you start producing electric vehicles at mass amounts, i.e., millions per year, you would run into problems of storage, recycling, and disposal of the used batteries. This is not a problem today because the amount of electric cars is low and most of them are still in operation. Will the grid be able to handle millions of cars? It can handle tens of thousands of

cars in every country, but can it handle a million cars in Germany?

In many countries the sale of electric vehicles depends on subsidies. In Denmark and Singapore, when the subsidies ended, electric vehicle sales almost went to zero. It is one thing to support small sales and something else to support hundreds of thousands or even millions of cars being sold. That would be a lot of money for the government to pay. It is not a given the future belongs to electric vehicles. It might be eventually, but it may be further down the road. Tesla is completely dependent on this whereas the other car companies are not.

Q: In terms of the scale of BMW versus some of the largest automakers like GM which roughly maybe produces 10 million cars a year, do you see any risk there that BMW may be too small to make all the required investments to develop future technologies?

A: I don't think so, it hasn't been the case so far, and nothing suggests it would be the case in the near future. They still produce 4 or 5 billion net free cash flow per year, after spending 4 million per year on R&D; and it does not seem to be the case they are falling behind the competition. It is true that with something over 2 million cars sold per year they are smaller than GM or Volkswagen or Toyota, but they are a premium car manufacturer they are more comparable to Daimler which is their closest peer. Excepting the trucks, vans and bus business, Daimler is almost the same as BMW. There are also smaller, and I don't think it's necessary to be the largest. It is the choice of BMW to be in a premium segment, and it would be a mistake to go into the mass production.

Apart from the premium segment, there is the introductory segment and the mass production segment. It seems to be a good idea for BMW to stay in the premium segment because the margins are the biggest and the business is less volatile than the mass production. Also, electric vehicles adoption is mostly by people buying in the premium segment which is the case for Tesla, or the introductory segment, which is the case of Nissan. This is where the progress of electrification would be the fastest. I don't think the mass segment would be Daimler. BMW is well-positioned for the future. By having zero debt and 22 billion net cash, they have sufficient resources to handle the transition.

Q: Touching on the peak auto point, you talked about places like China, still having growth ahead. Could you shed a bit more light on BMW's competitive position in China or any other large emerging markets where they need to also contend with the local competition?

A: Yes, they are strong in China, but it may be the only emerging market that could be described as such. They have a relatively weak position in Russia, in India in Brazil, and in Turkey. China is the only emerging market that stands out. The question is whether you see this as a weakness or an opportunity for the future. I don't know why it is the case because in Russia, for example, you can see Mercedes is strong, and there is no reason why BMW shouldn't be strong either. I don't know why they are weaker in these emerging markets, and I haven't been able to figure this out, but this could also be an opportunity for the future.

Having said that, these markets are smaller with respect to vehicle sales. For example,

vehicle sales in the European market [in 2017] would be about 17.3 million. Germany is 3.6 million, UK 2.9 million, and France 2.4 million — BMW's largest European markets. The Russian market altogether is 11.5 million, the Turkish market 1 million. Put together, Russia, Turkey, Brazil, Mexico and even India, would equal the size of Germany, UK, France and Italy. These are large countries, but the sale of premium vehicles will be still smaller than in Western Europe.

Q: Your sum-of-the-parts valuation did not include the car-sharing business of BMW, the DriveNow joint venture with Sixt. Do you have a view on the value of that?

A: I haven't been able to figure out the value of this business. I assume it is still pretty small, but BMW wants to be an important player in the car-sharing business in the future, but so far it would be a rounding number in evaluation. You could also add things like, the potential risk of a fine of your diesel scandal or Carter scandal you know in Germany and other markets, which has seen speculation about. BMW was never implicated and keeps denying anything, but this could come up at any time, so you can also say maybe a few billion euros can be deducted, you might also deduct the pension liability but as soon as the interest rates go higher a bit that liability would go down. I wanted to state at the reasonable level of granularity, not to confuse things too much. But for car-sharing business, it is tiny for them at the moment.

About the instructor:

Daniel Gladis, based in the Czech Republic, has amassed a market-beating track record since starting VLTAVA Fund in 2004. VLTAVA Fund is a value-oriented, research-driven investment fund focused on investing in good companies run by quality management. Previously, Daniel was Director and Chairman of the Board of Directors of ABN AMRO Asset Management (Czech) from 1999-2004. He was also Director and founder of Atlantik finanční trhy, a.s., a member of the Prague Stock Exchange. Daniel is a graduate of VUT Brno and has authored the best-selling book Naučte se investovat (Learn to Invest).

“May you read this at a time when bargains are rare.”

If you do, it will mean that, looking in the rear-view mirror, “pain” has been (hopefully) kept to a minimum. However, it is not only enjoyable and profitable to have participated in equity markets that have advanced during a prolonged bull market, but it may also result in some potentially thorny dilemmas:

When is the right time to sell securities that have appreciated?

How should a portfolio be positioned near a potential market top?

What should an investor do, literally, with his or her time?

We focused primarily on the last question in our exclusive conversation with Daniel Gladiš, returning instructor at [European Investing Summit](#) and chief executive officer of Vltava Fund. We spoke with Daniel in the summer of 2014. His insights remain highly relevant.

A few highlights from the exclusive conversation:

You still have to do the work every day, but at the end of the day, there’s no trade. It looks like we haven’t done anything, but we’re getting ready for a time when prices will be attractive again and we can start buying.

You have a choice: invest money and be satisfied that returns will be much smaller than they used to be, or you can sit, accumulate cash, and wait for better prices.

The longer your horizon, the more important the quality and the growth potential of the company and the less important the price.

When looking at an investment opportunity, one risk is you lose money forever, i.e., a permanent loss. The other risk is you do not make inflation over time.

The older I get, the greater my tendency to see things as simply as possible. When I started investing two decades ago, I didn’t know what I was doing, but even one decade ago I was doing things in too complicated a way.

In countries like Russia or China, the people are corrupted by communism. They do not see a shareholder as someone they should be working for. They see shareholders as sources of capital.

(The following transcript has been edited for space and clarity.)

John Mihaljevic, MOI Global: What is there to do when there's not a lot to do in the markets?

Daniel Gladiš: 2009 was an exceptional year because everything was so dirt cheap. It was unusual. In 2010-2011, when the markets had already recovered substantially, you could still find fantastic businesses at fantastic prices. As Buffett says, you could feel like an oversexed man in a harem. Today, it is difficult to find good ideas. I can't find any good ideas among the mainstream companies. The only good ideas are basically niche cases — a spinoff here or a special finance opportunity there. You have to learn to be okay with it. Don't force yourself to do too many transactions.

It doesn't mean you leave the office for several months. You still have to do the work every day, but at the end of the day, there's no trade. It looks like we haven't done anything, but we're getting ready for a time when prices will be attractive again and we can start buying. As they say, the market doesn't give you a return whenever you need it. You have to respect that at the moment the market offers a low return. You have a choice: invest money and be satisfied that returns will be much smaller than they used to be, or you can sit, accumulate cash, and wait for better prices. I can't say which is better because if the wait lasts several years, it's better to be invested.

MOI: Peter Cundill has been quoted as saying, "There's always something to do." Maybe *what* you do changes depending on the availability of bargains in the market. We are not here to try to forecast the market, but rather to learn about what a value investor can do productively when bargains are not widely available.

Gladiš: Just do your daily work. The knowledge and data accumulate. When the time comes, you'll be ready. Every day we read and look for good companies. We try to get ideas from different sources, some of them in systematic ways, some of them come unexpectedly. We build a universe of stocks we like or love. We try to have an idea what price is a good price, and we cultivate that universe. Often it does not result in any transaction. I don't think trades are something by which you should measure yourself. Most of the work and the value you create is in the preparation — in the studying and reading. Then you have to be patient and ready to act when the time comes. You have to know *what* to buy, you have to have the money, and you have to have the courage when the opportunity comes.

MOI: How do you look at valuation? Some investors say, if it's a great company and will compound for a long time, the price does not matter as much. On the other hand, we know from the experience of great investors that they pay a lot of attention to the price.

Gladiš: I don't have a precise answer because investing is not science. It is a matter of opinion and judgment. It also depends on the investment time horizon. The longer your horizon, the more important the quality and the growth potential of the company and the less important the price. If your horizon is very short, the long-term compounding means nothing.

We think of ourselves as long-term investors. We think in terms of *years* when we look for a stock. At the same time, there is a limit to what you want to pay. You can find the best businesses in the world, but if they offer a mid-single-digit free cash flow yield, it is not very exciting. If you knew that we would have zero inflation and zero interest rates for another ten years, that would be good. Otherwise, it's not sufficient. So, you have to look for free cash flow yields of 10% or higher, but then you have to make compromises on the quality. The risk is always higher.

Our biggest position is Berkshire Hathaway [as of July 2014]. I think you'll make a ~10% annualized return on Berkshire over a seven-year horizon [starting in 2014]. I consider it a low-risk company for many reasons. Whenever I look at an investment, I compare it to Berkshire, something where I can get 10% with very low risk. I need something that offers a bigger return, and then I have to judge whether it is worth accepting a higher risk. The older I get, the more risk averse I become.

MOI: You mentioned interest rates and your expectation of where they might be over time. How do interest rates or inflation figure into the price you are willing to pay?

Gladiš: They matter a lot. When looking at an investment opportunity, one risk is you lose money forever, i.e., a permanent loss. The other risk is you do not make inflation over time. Inflation is important, but I have no particular insight into what it will be. No one does. It cannot be much lower than it has been for the last five years. Something also tells inflation has been higher than governments are saying.

Interest rates are also important because you can use the rate you make on deposits or bonds as a comparison with stocks. Of course, once interest rates are too low, everything looks cheap because if you compare almost any good stock with an interest rate of 2.5%, it looks cheap. I feel that these rates cannot last forever. I stop using that comparison whenever the ten-year Treasury yield goes below 5-6% because I think you have to make much more on stocks. I have no idea where this [environment] will lead us, and I don't think anyone does because what's been happening with monetary policy around the world is so unprecedented.

MOI: It's interesting because you have found something — Berkshire Hathaway — where you feel you can get a fairly safe return of 10%, and that serves as a hurdle. Is that right?

Gladiš: Yes. You can use different stocks as a benchmark. You can use Coke or Nestle, but Berkshire is better because there is less single-stock risk there, as it is basically a conglomerate and is very well-run. It also offers a higher return than most of the other main stocks. I can always buy more Berkshire, so why would I buy Nestle where the return might be half of Berkshire's?

MOI: You've talked about being less active in times when valuations are less attractive. However, your portfolio needs to be invested in *something*, and that "something" may include cash. How do you think about an allocation to cash in the context of inflation?

Gladiš: I would never consider cash a reasonable long-term position. The cash we have is

basically a residual of our ability to find something good to buy. I have close to 20% in cash, but if I find something really good tomorrow, I would not have to have any cash. It don't sit on cash just to have cash. At the same time, I realize that holding cash gives you an option that might be very valuable in extreme cases. However, the extreme case doesn't have to come for another fifteen years. I don't think people should hold too much cash, because it's an asset that is losing every day [in real terms].

MOI: Some investors utilize strategies like short-selling or hedging through index puts when markets are elevated. What is your philosophy?

Gladiš: We don't hedge with puts. It would require market timing ability, which we don't have. We do use short positions. I see some sectors that are extremely overpriced... I firmly believe some of those stocks can go down 75% or more when people come to their senses.

MOI: When you talk about a 20% cash position, does that include the short exposure? How do you think about that?

Gladiš: Our net exposure is less than 80%, so the 20% cash is as a percentage of net asset value.

MOI: How active are you generally on the short side?

Gladiš: It's opportunistic and only a supplement to what we do. It's a minor part of our strategy.

MOI: I'd like to segue into a few other topics related to the course you taught at Masaryk University in Brno...

Gladiš: I had given many lectures at universities in the Czech Republic and Slovakia, but I was playing with the idea of doing something more comprehensive. I designed a course and taught it at Masaryk University. I enjoyed it very much.

MOI: How does the course differ from what you might find in traditional investing curricula?

Gladiš: It differs very much. I can't comment on foreign universities because when I look at what they teach in my country, it's very basic and insufficient. Without trying to sound too big, where they finish, I start. It is not being taught at all in my country. When I was a student and then started my brokerage business, I wanted to have a course like that but it was not available. It's still not available. I pictured what I would have liked to have 25 years ago and designed a course with that in mind. It's also time to start giving back some of the knowledge I've accumulated to the younger generation.

MOI: How much of the course focuses on valuation and topics related to security analysis versus business analysis and the ability to appraise whether a business has a wide moat?

Gladiš: The core is trying to teach people two things. The first is how to value a company, and the second is how to handle market fluctuations. Other topics are built around that —

circle of competence, margin of safety, market psychology, your own psychology, and the investment process, i.e., how to build a portfolio, how to find a good company, and corporate governance.

MOI: Was it not Warren Buffett who said if he could design a business school curriculum, there would be only those two topics...

Gladiš: It was him, and he's completely right. The older I get, the greater my tendency to see things as simply as possible. When I started investing two decades ago, I didn't know what I was doing, but even one decade ago I was doing things in too complicated a way. The basic ideas of investing are simple. As Buffett says, it's not easy, but it's not because people cannot understand the ideas. They are not difficult. People cannot handle and restrain themselves.

MOI: The media, academics, and even practitioners make investing seem hard. Maybe there's a desire to discourage competition or justify high pay. Let's accept that the precepts are fairly simple. What then makes it so difficult to execute?

Gladiš: It's people's nature. People have a tendency to do things the wrong way. They are not patient. They look for the quick money, which is very difficult. It's actually not difficult to make money in the long run in stocks. It's extremely difficult to make money in the short run, and the more you try, the more you lose, on average.

People are unable to stay the course. When there is a big correction, a lot of people throw in the towel and run away. They are overcome by emotion. They never figure out and define themselves — what they actually want to achieve. This makes it not easy, but investing itself is quite simple.

MOI: How do you avoid some of these biases or emotions coming in? Let's say you buy a security and it's down 50%. What goes through your mind, and how does your process deal with the dangers when something like that happens?

Gladiš: You must have the process well-defined in advance, and then you have to stick to it. You have to accept there will be errors and there will be cases you lose money.

You have to be honest with yourself. It's difficult to say, "Am I right or am I wrong?" You will only know retrospectively, but you cannot invest retrospectively. Even if you can put your emotions aside, it's difficult to make the correct judgment. However, if you have a well-defined investing process, you know what you are doing. You have to know what types of companies you are looking for, you have to have some idea about the valuation. You have to insist on a margin of safety, and you have to have management that works for shareholders.

If you have all of this then, on average, you'll be fine. If you buy 50 stocks over five or seven years then, on average, you'll be right. You'll have cases where you lose money, although losing money over the last six years was actually extremely difficult. A time will come again when it will not be difficult [to lose money].

MOI: How do you think about position sizing?

Gladiš: We have a relatively concentrated portfolio. We own 24 stocks [as of July 2014], and the top ten would represent ~75% of the portfolio. A conviction position would be 10-12%. We usually cut the size when it reaches 15% because it just doesn't feel right to us. We don't usually buy something smaller than 4%; a 2% position doesn't have an impact. You either want the stock or not. If you want it, you should put in more than 2%, and if you don't want it, you shouldn't even have 2% in it.

Sometimes when we have a new stock, we think we'll have a bigger position over time, but we build it carefully. We have found that when an idea is new, there's a chance you have overlooked something or you're wrong. That said, when we have something in the portfolio for seven or eight years, it rarely requires time to get up-to-date on the idea because you know the stock well. If we have owned something for longer, we're happy to have a big position. If it's really new, we would start slowly.

MOI: Is it just conviction that determines the size of a position or are there other things, such as the leverage of the company or something within the portfolio?

Gladiš: The leverage of the company is a part of the evaluation because we actually take leverage at a company level seriously. We still remember 2008, when some companies that needed capital at the end of the year were scrambling for survival. There's not only leverage at the portfolio level, but also at the company level. We prefer companies with little or no debt. Some stocks have zero debt, but people may argue it is suboptimal because those companies have their destiny completely in their own hands. They could never be forced to do something in order to get new capital or survive.

MOI: Talk to us about one or two industries you have found to be particularly fertile grounds for good investments?

Gladiš: First, I can tell you where we think there are no good ideas. There are some sectors we tend to completely avoid — mining companies, oil stocks, airlines, and heavy industries like telecoms — capital-intensive businesses. Few of these companies have any sustainable advantage. Usually, there is low free cash flow in these sectors. There are some sectors we don't understand, like biotech, so we don't even attempt to do anything there. That leaves about half the market out. We do invest in some technology but more "old" than "new" technology. We like insurance, some media companies, some wholesale trade companies, some food and beverage companies.

MOI: Touching on insurance, how do you think about free cash flow there?

Gladiš: The big insurance companies are extremely difficult to figure out, so we focus on the smaller ones with a simple business model. We prefer property and casualty insurance and reinsurance. We don't like life insurance. We like smaller companies, with single-digit billion-dollar capitalizations, run by people with big ownership, maybe even the founders. They know how to underwrite and how to price the insurance. An insurance business has capital requirements and no assets other than financial assets. It is people, contracts,

assets, and liabilities, so whatever they earn is basically free cash flow. They have almost no capital investments. We tend to judge these businesses by gross book value, for example, including dividends.

MOI: With regard to insurance companies in the context of inflation, they might invest the float in fixed-income securities, and they might have long-term obligations that could balloon with inflation. How do you assess such risks?

Gladiš: It depends on the duration of liabilities. You can see the duration of the asset side, as they normally publish the duration of the bond portfolio. In the case of property and casualty, it is usually quite short. The key is the duration of the liabilities. Some companies focus on the short end, so there is not a mismatch, but if you write contracts with a lot of duration, inflation can hurt you over time. We prefer those with shorter contracts.

MOI: You mentioned management ownership and conservatism are important when selecting an insurance company. What other sources of competitive advantage can an insurance company have over time?

Gladiš: Insurance is an interesting sector because they sell a commodity product, unless you find a firm that serves a special niche. Reinsurers and other insurers basically have standardized contracts often sold by intermediaries. It's a commodity, but there are big differences in combined ratios. Some insurance companies have consistently bad combined ratios while others have consistently good ratios. There must be a difference somewhere, and it's probably in the ability to price risk and to restrain yourself from selling insurance too cheaply. You will only find out several years later if the contracts sold today are cheap or not. For insurance companies owned and run by founders, the incentive to go for big growth at the expense of pricing is not there.

Management that is hired and compensated based on the size of the business has a tendency to sell a lot of insurance. In five or seven years, when the "judgment day" comes, you realize that they sold the contracts at a loss. The old management will probably not be there anymore. It will have been compensated for the growth. The shareholders pay the price later. We want companies that are owned by the managers or managed by the owners; the chance is lower that they have the wrong intentions.

MOI: There may be a distinction between top management and the layer of people who actually underwrite and put risk on the balance sheet. What kind of incentive or employment agreements do you like to see to get comfortable?

Gladiš: It is good if the insurance specialists get compensated after the contracts expire, not when they are sold. This happens mostly in the smaller or mid-sized insurance companies. I could never figure out companies like Munich Re or AXA. You simply don't know what huge insurance conglomerates own.

MOI: Is there a timing aspect to insurance investing in terms of the cycles of pricing?

Gladiš: Insurance has its own cycle. It's not correlated with the normal business cycle,

which is also good because there is lower correlation with the rest of the portfolio. The cycle depends on the availability of capital in the business. When there is a catastrophic year, capital goes down and prices go up. When there is a benign year, it reverses.

At the moment [as of mid-2014], the market is soft. There has not been a bad year for two years and interest rates are low. It is an environment in which discipline by the insurer is extremely important. Many insurance companies have excess capital. You will probably see them returning capital to shareholders, which is what they should be doing.

MOI: Based on your experience in financial services and the brokerage sector, how would you evaluate banks like Deutsche Bank or Barclays?

Gladiš: I would stay away from banks in Europe completely because they are still very undercapitalized. They do not admit to the [lack of] quality of their assets. They have been postponing the hard decisions. In this way, Europe differs from the U.S. If the U.S. has a problem, there's a tendency to write off, recapitalize, and move on. In Europe, the tendency is to "extend and pretend" — pretend that the problem is not really there. They think, if you keep pretending and putting it off, something good might happen. Many European banks were surprisingly low on capital, and Deutsche Bank is a good example.

I read an article in the *Financial Times* about Spanish banks having 12-25% non-performing loans — terrifying numbers. It's 12%, but if they include the real estate they acquired as collateral, which is also non-performing, it might be twice as much. Those banks are basically insolvent again. Even worse, there is now bigger feedback between the country and its banks. Before the 2007-2008 crisis, the sovereign bonds were owned by banks from many countries. Recently, a much bigger percentage of sovereign bonds has been owned by banks of the same country. It's more fragile than it was before.

MOI: What are some countries you stay away from and where have you found, generally, the alignment of interest you look for?

Gladiš: We have maybe 80% invested in developed markets, i.e., the U.S. and Western Europe. I live in an emerging country, so it's not that I have any prejudice or tendency to avoid emerging markets. Over time, we have come to the conclusion that there are few good businesses with good corporate governance at a good price. There are a lot of good businesses there, but the best businesses tend to be in the West.

There is an annual list of Top 100 brands globally. Of those, ~80 are from the U.S. The rest is from Western Europe, Japan, Korea... There is nothing there from Russia, China, India, or Brazil. They don't have any global brands. In the small and medium companies, it's the same. Even if you find businesses that look good, you almost always run into corporate governance problems. We would love to have investments in other parts of the world, but I can't find any. The very few that are there are already expensive.

MOI: In terms of corporate governance, it's fascinating because there are so many examples of companies in the U.S. that have created enormous wealth for the founders and investors by having good corporate governance. The message hasn't gotten through to

companies in emerging markets. Do you think it has to do with immaturity or market structures or is it something in the mindset of the entrepreneurs they need to overcome, in which case it may take much longer?

Gladiš: In countries like Russia or China, the people are corrupted by communism. They do not see a shareholder as someone they should be working for. They see shareholders as sources of capital. Those are markets in which you put capital and never get it back. My country was the same in the 1990s.

If the Russian market trades at five times earnings, there must be a reason. It's not because nobody knows about it or nobody pays attention. The reason is that five times earnings is what you *should* be paying in a corrupt environment.

China is the same. The Chinese market has been going down for the last two years while everything else was going up. It's the same problem. That's what communism does to people, and we should always be reminding the world about it.

MOI: As a contrarian investor, do you then look at a market like China and say, "That's a place I should look for bargains"?

Gladiš: We do look at them. I might be just contradicting myself because a couple of months ago we bought a Russian stock for the first time. That was a special case because the Ukrainian crisis broke out. Russian stocks went down a quarter and the currency as well. We just couldn't resist and bought a bit of one of the very few investable stocks in Russia. It's one of our smallest positions. I would never align our future with a market like that.

MOI: Do you believe Western companies are making some of the mistakes you are trying to avoid as an investor? Take Walmart, which is perceived as successful and growing in China. The government seems to have let them expand, but if you look at Walmart's investments into China, they may be generating profits from those stores, but free cash flow is likely still negative because capex is so high. How do you look at the wisdom of that capex in light of what you just said about, you can put capital in, but you won't get it out?

Gladiš: It might be right. The problem with Walmart is they do not publish country-by-country data. They may tell you how many supermarkets they opened or maybe what sales are, but you don't know if they are making money there or not.

It was the same with Tesco, which was supposedly doing well in Asia. However, when they got out of China, it was at a loss. It was a loss-making business, and it may well be the case of others as well. China is such a huge market that resource-rich companies like Walmart have to really try. I have no idea if they could succeed. They haven't succeeded in Germany, for example, a mature, rich country. They do reasonably well in the UK, Iceland, and Mexico, and very well in Brazil, so it varies from country to country. They would like to do something in India, but Indians make it impossible for anyone. You could say the same about car companies. They all go into China because it's a huge market, but how much money they make there is the question. Is IBM making money in China, or Oracle? We don't know. McDonald's, Coca-Cola? China is one-fifth of the world's population. They have to be there.

MOI: You talked about industries you stay away from, not because you couldn't understand them, but the economics are bad. You mentioned airlines. A lot of airline equities have done well. Do you track those kinds of industries in some way to determine whether at some point the economics of the business have changed to a big enough degree?

Gladiš: We follow the airlines from a distance. I still think that the industry characteristics haven't changed. I don't think any airlines have brand value. I flew today from Vienna to Munich to Napoli. We flew Lufthansa. If the flight was Austrian Airlines or Air France or Air Italia, I wouldn't care. I would buy whatever is the most convenient time or price. It is also an extremely capital-intensive industry. I don't see much free cash flow there. This is not a good way to be making money. There must be a reason Warren Buffett has not owned an airline in six decades of his investment life. I think he has not owned a telecom company either.

MOI: He has owned the preferred stock of an airline, but he mentions that...

Gladiš: ...it was one of his big mistakes in the 1980s.

MOI: It's interesting because some of the airline stocks have run, but maybe in your view it's just a cyclical factor where they've taken out some capacity and they're seeing good pricing, but you're not seeing any change in the fundamental business models.

Gladiš: I don't think so, no.

[Editor's note: Berkshire Hathaway subsequently, during 2016 and 2017, disclosed stakes in airline stocks. Those investment decisions may not have been made directly by Buffett.]

MOI: Are there industries you have felt better about over time? Some value investors invested in GM after the restructuring...

Gladiš: We had GM one to two years ago. That was a special situation: It came back to the market with much lower debt and got rid of the government ownership, and bought back some of shares. It was extremely cheap in the low \$20s, so we bought it. I wouldn't see this as something I would hold for a long time. The core of our portfolio are companies we could own for years and years. It doesn't mean you close your eyes when you are presented with an opportunistic idea like GM or Hewlett-Packard or some spinoff. You buy it, hold it for a month or a year or two. When the price is right, you get out. There is nothing wrong with being opportunistic, but it will always be a small part of the portfolio.

MOI: Some investors think of their portfolio as different buckets, whether it's "great businesses at good prices" or "special situations". Do you have that mindset?

Gladiš: I do, although it's not strict. I see the portfolio as three levels:

Level 1 are the highest-quality businesses you can find. There are not many of them, maybe 20, 30, or 40 in the world, not more than that. Most of them are expensive, but if you are able to buy them at good prices, you can basically hold them forever. You only sell them in

two cases: (a) they become so expensive that it does not make any sense to hold them, or (b) if there is a market crash. They normally go down much less, giving you cash for better opportunities. Otherwise, you could own them forever. About a quarter of our portfolio sits there.

Level 2 are very good companies you would be happy to own for a long time, but they are not the Coca-Colas or Berkshires of the world. They are solid businesses, but below the top level. This is about two-thirds of the portfolio.

Level 3 are opportunistic situations. Sometimes you have none and sometimes you have several. You don't plan for them, but it doesn't make sense not to do them just because they are not top businesses. You can make very good money there.

MOI: I want to go back to where we started, which was “what to do when there's nothing to do”. How do you spend your time in terms of expanding your circle of competence over time?

Gladiš: I read. It's as simple as that. I read as much as I can, not because I have to. I like reading. It's a good “waste of time”. There's always a pile of books on my desk. During the day, I mostly read stuff on companies — articles, research and annual reports, etc. In the evening, in my “free time”, I read books. Some of them are business books, some are novels. Some are biographies, which I find very interesting. Some can be physics or anatomy books — anything. I'm curious about everything.

This conversation was recorded on July 15, 2014.

In an episode of [The Zurich Project Podcast](#), presented by MOI Global, John Mihaljevic speaks with Daniel Gladis about the importance of attracting the right clients. Daniel, chief executive and portfolio manager of Vltava Fund, explains why having the right type of investors is a necessity for long-term survival and success in investment management. The conversation delves into client selection and ongoing client communications.

Daniel is based in the Czech Republic and has built an impressive long-term investment track record. He is a participant in [The Zurich Project](#).

The Zurich Project Podcast is on [iTunes](#), [Soundcloud](#), and [Stitcher](#).

The following transcript has been edited for space and clarity.

John Mihaljevic, The Manual of Ideas: It's always a great pleasure for me to have an opportunity to speak with Daniel Gladiš, Chief Executive Officer of Vltava Fund, based in the Czech Republic. Those of you who are members of our community will know Daniel quite well by now. He has given us insightful interviews as well as presented at several Value Conferences in the past, and his ideas have just been incredible – not just from a performance standpoint but also from the way that Daniel puts together his investment thesis. He has run Vltava Fund since 2004 and has beaten the market soundly by following a value-oriented, research-driven investment approach.

Daniel, I'm very much looking forward to having you with us at the Zurich Project. What I thought we could discuss now is the importance of having the right type of investors, something that I feel like is often overlooked but may in fact be a necessity for long-term survival and success. So, I look forward to your thoughts on the topic and then I'll just mention, obviously, we can continue this discussion in Zurich as well with those who are interested. So, tell me why you thought we should discuss this particular topic.

Daniel Gladiš: Well, first of all, thank you for the invitation, John. It's always a pleasure for me to be a host or a guest at one of your events. I really enjoy it very much. When you came up with this suggestion to do podcasts and I thought about what we should talk about, I think one of the topics I've been thinking about for years now – and it's not very often covered – is how important it is to have the right sort of investors for your fund to achieve success, so I suggested this topic and I'll be happy to share with you my thoughts. It's not a rocket science. There is a lot of subjective input into it, but I think this is something that is very important.

MOI: Absolutely, and I think, you know, I've also come across some scepticism when you mention the topic because a lot of folks are really struggling to get money in the door and this notion that you should actually pick and choose your clients seems almost a little arrogant, but why do you think it's actually a necessity over the long term?

Gladiš: Well, let me explain. I think at the end you should probably reject some clients, but let me get to that point step by step. I think when people start a business like a fund or a hedge fund, they may have different motivations. Of course, a financial motivation is important for everyone, but there are other motivations as well. Sometimes, people just want to start a fund because they like that kind of activity. They just like doing it, and also I know a lot of fund managers that feel good about the fact that they are helping others by offering them investment services. So, there could be various motivations. And I think when you start you should realize what your main motivation is, and then, when you look back at your own business, there are a number of criteria that you can use to evaluate whether you are successful or not.

Of course, the investment performance is important, but, if we set the performance aside – because running a fund is not only simply about managing money, but it's also operating a business – so there are other criteria for success evaluation. It could be size of your fund or the size of the business. It could be the stability – the stability of your business, the stability of your investor core. It could be the recognition you receive from not only your investors but from the wider public, and it certainly could be a pleasure from the work that you're doing and also from the relationships that you have with people that you serve, or from your clients. So, there are a number of evaluation criteria, and they do have a common denominator. That is that it is really very important and critical that you have the right type of investors to be successful, because, if you don't, then you may not be large enough, your business will not be stable, you will not have the satisfaction from working with pleasant people or people that share your investment philosophy, etc.

When you look at what kind of investors you may have, of course, there are various types of investors. When most people start a fund, they start with partners and friends and family and then they move along to high income individuals and they work with seeders. Then they can work with funds of funds, and, if they get some track record and they are bigger, they can work with family offices, they can use third-party marketers, foundations, endowments, pension funds and even sovereign wealth funds. So, there really are various types of investors – not only individual and institutional, small and large, but really different types. There are investors that are direct investors, and then there are investors which are not direct and they are represented by an agent or by a middle man or by another fund. And this is all important.

So, when you think about what type of investors is good for you, it should be such that fulfils the following criteria: I think the right customer, or right investor, should understand your philosophy. That means they should be willing and able to understand it. They should understand the approach you have, your goals, your investment horizons, how you define risk, etc. Well, it sounds nice, but from our experience, this is very difficult to achieve in practice, because investors must be not only willing, but also able to look, learn, and understand what you're doing – and this is very difficult. We've been trying to educate investors for 14 years now, or 15 years, and very often what happens is that, if you ask them, they say, "Yes, we understand what you're doing. We share your thoughts, we agree with it." And then when you ask them to actually formulate what they think you are doing, very often they are not able to, so there's always some misunderstanding. There's always a

misreading in perceptions and expectations, etc.

Another thing to consider is should I offer what the people want or should I do what I think is right and then try to find investors that fit into this? There are two different types, but I think the right steps for achieving the right type of investors are the following: First of all, we should focus on the right types of investors in general. As I said, there are individuals, there are institutions and they have different expectations, different horizons, different criteria. If you focus on the wrong groups, then the probability of your success is lower. It's the same like in investing, you know, if you focus on sectors or industries where there is a high probability of success, then you'll probably find good investments. If you focus on the wrong industries, on the wrong countries, on the wrong types of companies, then you'll probably not succeed. It's the same in working with investors.

If you want to find the right types of investors, you have to realize first who they are and then to target them - and do not target other types of investors. You should do all you can before they become investors in order so that they understand your business. This is important, this is absolutely critical because if you accept a customer or an investor that does not understand what you are doing or does not agree with what you are doing and is joining you only because he likes your performance or only because someone has recommended it to him or someone just sold it to him, this is not good, because, sooner or later, this will result in dissatisfaction on both sides - on your side and the side of the investor. So you have to make sure that you do everything you can before someone becomes an investor so that he understands what you're doing, which means also that you should absolutely not take everyone that offers you money.

Now, there's a conflict between size and quality of your business. If you make size of your business the #1 priority - which is fine; I'm not telling what people should do - but then you should realize that you have to make sacrifices on the qualities of your business. On the other hand, if you put priority on the quality of the business, which means the quality and stability of your investors, then you should sacrifice probably something on the side of the size of the fund and you probably cannot do both at the same time. Then, when time goes on, and even if you do everything you can to accept only the right clients, then it's inevitable that, during your business, you will realize that some of your investors are not the right ones. So, what can you do?

Well, I think the best way, actually, is to discourage them from further investments in your fund. It sounds crazy, but I think it's better for both you and them, because if there's people in your fund that shouldn't be there in the first place because they expected something else or they had different horizons, they never actually accepted what your investment philosophy is, they're unhappy and you're also unhappy. I think a relationship like that lowers the quality of the business, and I think you should, in some way - I don't know in what way, there might be different ways for different funds - basically discourage them from at least further investments, but maybe from staying in your fund at all.

It is also very important that you control the selling process of your fund, because if you enable third parties to distribute your fund, it means that you give up a lot of control over who becomes your investor. You don't know what your new investors are being told, what

they're being promised, what expectations they create before they become investors and this is very dangerous because there's a conflict, of course. There's a conflict between you as a principal of your business and your desires, there's a conflict between someone who sells your fund because their motivation is probably very different from yours. So, I think the best way to achieve the highest quality is to absolutely control the process over who becomes your investor. But I understand that for some fund managers or for many fund managers, this is either too restraining or too difficult or might be even too costly, and they want other people to sell their funds. But then they have to realize the dangers that you're getting with it.

Then, as the fund goes on, as the business goes on, you must make the communication with investors your top priority, because as the fund gets bigger and your client base grows, it becomes more time-consuming and more costly to constantly communicate on a one-to-one basis with everyone, so you have to design ways of communications for communicating with investors all the time, because even if you think that they understand what you're doing, that they accept it and they like it, don't get too complacent. You have to repeat the same things over and over and over, because people tend to forget. They tend to deviate from their original understandings and, very often, they just get distracted and basically they say they understand what you're doing, but they don't. So you have to repeat the same thing over and over and over all the time. Communicating with investors during their investments is very important. Last but not least, I think you have to be very patient and consistent. If you're in a hurry to grow your business, you'll probably get a lot of rubbish in your fund, so being patient and working slowly I think pays well in the end. So, those are my thoughts. I have some other thoughts, but maybe you want to jump in with your comments now, John.

MOI: Yes, thank you so much for laying it out so clearly. Maybe on the investor communications part I'd like to go a little bit deeper in terms of how often you might want to communicate, what you actually want to put in those letters. I know you don't discuss live ideas in your letters, so just tell us why you decided on the modalities that you did.

Gladis: Well, they've evolved over time. We have various frequencies of various types of communication. We have a monthly fact sheet, which gives you monthly NAV, but also gives you a set of basic data, including top investments, basic statistics and allocations, etc. But then we have quarterly letters, which are basically designed for both existing and potential investors. We try to explain what we do and what our thoughts are on various actual topics. We discuss only investments that we have closed in these letters, because it's been widely read and we don't want to give up our ideas publicly too soon. Then we have various presentations and an annual gathering for investors where we are more open and we discuss everything in detail. These are the standard ways of communications. Then, too, we do meet with investors throughout the year on a one-on-one basis, but this is very time-consuming, so we have two or three dedicated people just to do that. This is very efficient and brings new business, but it is also very time-consuming. And then we organize various other events. We organize conferences, we organize seminars - so we try to do a lot of communication, and I think it's very, very important. I think one mistake that I see very often in other funds that come and go is that very often they just start a fund with an idea, "Yes, I'm going to start a fund and start managing money and then people will

come,” but people never come. If you don’t try to get them very actively, they will not come on their own. It doesn’t work like that, so I think you should make marketing and communication and business development – whatever you call it – a top priority right from the beginning. And it’s a very different function from running money. It’s inevitable that the fund manager himself or herself gets involved because he is the one that is the source of the ideas, but he cannot do it alone. You have to have other people that are basically designated and dedicated to the marketing activity.

You should also realize that you will never achieve the perfect or ideal setup, but if you know what you want to achieve, then you might get close. Basically, I see this as a trade-off between the quality of your business and the size of your business. I think if you prefer quality, then your business will grow anyway, your satisfaction will be higher, and money, even if it might not be your #1 priority, will follow in the end anyway. So, these are the criteria that we use and I think that they work well. Another thing that I think is important is that, as the time progresses, you may want to – or you may have to – target different types of investors at various phases of your business. Of course, when you start a fund, there is no track record, it’s a small size, you could hardly get a sovereign wealth fund as your seed investor, right, so typically people start with their family and friends and partners when they start a fund. Then they can move along as the fund gets a track record and gets bigger in size to other types of investors and eventually they might end up with large institutions, and this is fine, but doing it the other way around is probably not a good idea. So, yes, you may have different preferences at different phases of your business.

MOI: I assume to date you’ve had mainly individual investors in the fund. In terms of communication between individual investors versus institutions, do you think there are any major differences there to be aware of, and how do you actually pick the institutions? That seems even more difficult than picking the right individual investors.

Gladis: Yes, the communication is very different. Individual investors, even if they are very rich, they don’t really care about, you know, ratios and tracking errors and Sortino ratios and drawdowns, and stuff like that. They basically use more common sense than hard finance, and you should also communicate with them in this way. It doesn’t mean at all that they are less advanced or so, they just view things differently, but I think they are probably a better, more stable source of investors for smaller funds. We market our funds primarily to individuals from various European countries, and we find this to be the best source of money, because, first of all, they are end-investors, so they have no one to report to. They don’t have any supervisors or bosses or boards or their own clients. They are end-investors, which means that they are making their own decisions. They usually are very long-term oriented, and they do not succumb to herd behaviour. They are not hot money. They make their own decisions, and they usually are more stable. They’re also a good source of references for other clients, so I find this to be a very stable client base.

I realize that our fund could be bigger if we were more aggressive and if we were using third-party marketers and if we were more after institutional money, but I think the client base would not be as stable as it is right now because our client turnover is something like 2% a year. It’s usually very low – and a lot of that comes from people divorcing and people

dying, unfortunately, as well. So, there are natural causes for client turnover, but otherwise it is a very, very stable client base.

MOI: If you wanted to look to some institutions, what would be your ranking of the types of institutions to go after? Would you look at university endowments or family offices? Where would you get started?

Gladiš: Probably family offices, because they are the closest to what we have right now. And we do have some. Then probably endowments would be a natural extension because, again, their investment horizon is very long and they are more stable than, for example, funds of funds. We do fight certain prejudices, because we are based in Eastern Europe, and it's very difficult to attract Western money from here. That's also a reason why we focus on high net worth individuals, because they do not have this barrier as much as do institutions.

MOI: In terms of the structure of the fund, meaning frequency of withdrawals and things of that nature, have you looked into ways to use some of those tools in order to help you discourage the kinds of clients that you would not want in the fund?

Gladiš: Not really. I'll tell you what we have. We have monthly liquidity, so there are no lock-in periods, etc.. Anyone can come in and out every month, but what we do have is we have a redemption fee, which is 2.5% of the redeemed amount, except in February when it's zero. This is a funny arrangement, but what we wanted to achieve is to discourage hot money, because we do not want money that comes in in March and goes out in July and gets back in in October, etc. We want investors to be able to think first what pocket of their own money they're giving to us, and we only want long-term money. So, if someone thinks in the short-term, don't come, and the redemption fee is meant to be a discouragement. But then what we found out in practice is actually that this also works to prevent investors from acting emotionally throughout the year.

For example, last year when there was the Brexit and the market crashed after that, a lot of investors around the world started panicking and they were redeeming money from various funds...because emotionally they were scared, they were panicking. When they want to redeem from our fund, the redemption fee is preventing them from overreacting to their emotions, which in retrospect almost always seems a good thing to do. Our redemption fee, even if it's not meant to be such, it was not meant to have this effect in the first place, it actually prevents investors from overreacting to short-term market developments. And over the last 14 years, it's almost always been a good idea not to do anything. So, yes, we have a funny redemption fee structure, but so far it's been working very well.

MOI: You are organized as a SICAV. How much flexibility does that structure give you to tweak things like redemption fees? Could you have a redemption fee that's based on the length (of time) that someone has been in the fund? What are some of the limitations that SICAV puts on you that maybe where you might do something differently if it weren't for the regulations?

Gladiš: Well, the regulation in general in the last several years has gotten tougher and tougher and in many ways, just crazy, but, for the fee structure, especially for the redemption fees, I haven't seen any limitations. You have pretty much full flexibility in how

you want to structure it, but we have not explored this subject because our fee structure has been the same for 15 years and we don't want to change it. But I think that there are no limitations here. You are very flexible.

MOI: Great. Well, I found this very helpful, Daniel. Any other thoughts that you'd like to share on this topic?

Gladiš: No, I think we've covered our thoughts, but if this podcast is especially dedicated for the participants of the Zurich Project, then I would be happy to have discussion with friends and colleagues there about this anytime they want.

MOI: Absolutely. I think this is a topic that's on the minds of many and it's also something that maybe gains in importance over time as you kind of maybe realize that you have some folks in the fund who are really more of a headache than an asset.

Gladiš: Yes, it is inevitable because you're working with people, and you may be getting above average people with regard to their wealth, but you're getting average regarding their temperament, so it's inevitable that you will have always - always - some people that will love you regardless of what you do, but that you also have people that are complaining regardless of what you do. That's just part of the business, but I'm not complaining. This is what everyone else has to expect.

MOI: Great. Well, certainly an important topic to really give a lot of thought to as a fund manager and I know that different people will come to different conclusions about the types of investors they want to have, but, at the very least, one should really think this through because probably for nobody is it optimal to just accept any money that wants to come in.

Gladiš: There are thousands and thousands of funds, so there might be thousands and thousands of approaches, but at least everyone, I think, should think about this before they start a business.

A formula for wealth creation

One of long-term investors' most common errors consists in trying to place their investments into asset classes offering only very little hope for generating high returns. Thus, they are depriving themselves of the possibility to achieve really high earnings. Each asset class (cash, bonds, equity, real estate, gold, and others) has its own characteristics, and one of the main ones is that of long-term expected returns. Simply put, if you want to have high returns, the majority of the portfolio must consist of an asset class that allows achieving such returns. Which is it?

Let us start by presenting certain facts about where wealth is created and the historical returns of the basic asset classes. Then we will think about why these things are as they are and, above all, whether this will remain so also in future.

Forbes magazine regularly publishes rankings of the richest people in the world. About a year ago, it occurred to me to take look at what made the world's richest people rich.

What I found was that 48 of the world's 50 richest people earned their wealth due to owning equity in some company, and the remaining 2 did so by investing into real estate. There is not one among the richest people in the world who built their wealth by hoarding cash or gold or by investing into land or bonds. As we shall see later, this is no coincidence. Equities are unequivocally king, and it does not matter whether this consists of an equity share in a publicly traded company (like Jeff Bezos and Amazon or Warren Buffett and Berkshire) or in a private one (such as Michael Bloomberg and Bloomberg).

The Czech Republic also provides a nice example of this. In the list of Czech billionaires, you will scarcely find anyone who has acquired his or her wealth in any way other than by owning stock in some company, and in almost all cases these are private companies that are not traded on the stock markets. The basis of investing into stocks is regular flow of cash from the companies to their shareholders in the forms of dividends and share buybacks along with reinvesting retained earnings. This is true for both publicly traded and private shares.

A second basic set of facts concerns historical returns of basic asset classes. Jeremy Siegel in his legendary book *Stocks for the Long Run* presents a nice graph with real – that is, inflation-adjusted – returns of basic asset classes in the US for the period 1802–2015. The returns are as follow: Cash yielded a loss of 95%, gold had real returns of less than 3-fold, treasury bills (essentially close to bank deposits) had 273-fold returns, bonds 1,659-fold, and stocks more than 1,000,000-fold. (In addition, perhaps to the surprise of many, stocks also had the lowest deviation from their long-term trend.)

Some may wonder why there is no real estate in the graph. It is difficult to assemble long-term real estate indices, and they are few and far between. Probably the longest series is that of the Case–Shiller Home Price Index for residential real estate, starting back in 1890. In the 127 years from 1890 to 2017, its value has increased by approximately 8.5 times in nominal terms and by 70% in real terms, after adjusting for inflation. The low returns from residential real estate put it closest to gold.

There are very great differences among the returns from the individual asset classes. That is just a fact. A question, however, is whether this is by chance or if there is some clear logic behind it. And how do these historical returns of the individual asset classes relate to the fact

that the world's richest people acquired their wealth almost without exception due to equity ownership? Is this not just a coincidence?

What in fact determines what the returns of the individual asset classes will be? I believe there are three main factors. These comprise the human factor, basic risk compensation, and capital accumulation.

The human factor. We can imagine every company as a living organism in which people create value through their activities, their ideas, creativity, effort, work. Through all this, they contribute to growth in the value of the companies in which they work. The influence of the human factor may not always be positive, but it is unequivocally positive on average. No one really doubts the influence people such as Bill Gates, Steve Jobs, and Amancio Ortega have had on the value of their companies. But we need not think in such extremes. The same effect of the human factor can be observed in firms all around us, and value is not created by leaders only but by everyone working in a company.

The influence of the human factor and value creation is much greater in companies than in, for example, land and real estate. Although people do create value there, it is greatly limited by the size, character, and location of

the particular property. In the case of companies, people have much more room for creativity and companies are much more flexible in responding to external developments and exploiting various opportunities. The influence of the human factor on bonds is minimal, and it is zero in the cases of cash and gold. Whatever you do, you will not influence the price of gold on world markets or change the nominal value of a bank note.

Risk compensation. When a company gets into trouble, the creditors' claims take precedence over the demands of shareholders. It is therefore logical that investors want to be compensated by higher returns for the risk they undertake in relation to owning a company's stocks vis-à-vis returns to those investing into its bonds. Over the long term, equities must therefore return more than bonds. The opposite relationship would make no sense. If lending to companies brought more money than their ownership, no one would want to establish companies. Everyone would just want to lend, but there would be no one to lend to. Again, real estate falls somewhere between stocks and bonds. Cash is at the lowest position, because its nominal value does not change. Gold is in a category of its own. It has no intrinsic, fundamental value,

generates no returns, does not multiply, and is not useful for very much.

Capital accumulation. Perhaps the strongest reason in support of investing into stocks is the speed at which accumulation of capital takes place at the level of owned companies. If, for example, a company has equity of one billion and return on equity of 15%, then its annual profit would be 150 million. If it reinvests this entire sum, which means equity at the beginning of the second year will be 1.15 billion, and if the rate of return on equity remains the same, then its profit in the second year will be 172.5 million. And so on year after year.

The trick lies in the fact that in stocks the returns to capital and the rate of capital accumulation are incomparably higher than in other asset classes. The proverbial snowball rolls up fastest in stocks, by far. Of course, capital accumulation occurs also in bonds, real estate, or land, but at a much slower rate. It does not occur at all in the cases of cash and gold.

This brings us to something we could call the Formula for Wealth Creation. This is what it looks like:

Wealth = (Human factor + Risk) * Capital accumulation

If we want to have high long-term returns, then we must invest into asset classes in which the human factor substantially helps to grow value, where the general risk undertaken is compensated by high return, and where rapid accumulation of capital occurs. As we have seen above, equities offer the best outcomes regarding all three points, and especially in their combination. We do not know how great will be the returns of the individual asset classes in the coming decades. They could be higher or lower than in the past. The crucial thing is that the ratios between the returns from the individual asset classes will remain. That means stocks will make much more money than bonds, real estate, gold, and cash.

Invest with care!

Daniel Gladiš, 18 January 2018

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The fact that the world's richest people – almost without exception – built their wealth through stock ownership is no coincidence. This aspect of the ranking will not change in 5, 10, or 50 years. Ownership of stocks in smaller amounts has the same impact on wealth. Even among the common people, the middle class, and entrepreneurs, those who own a share of some company will be wealthier than those who do not. In many cases, these will be private companies. The three factors of wealth creation have the same effect on their returns as they do on those of publicly traded companies. The disadvantage is that shares in these companies cannot be freely acquired and traded. Luckily, there are equity markets. The best thing about them is that they allow anyone to acquire shares in various companies all over the world and to put their capital to work at negligible cost. Essentially, at any time and without limitations. Freedom to such an extent is all too scarce in today's world.



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The sad case of the gold miners

Gold is considered a precious metal because it has been used for a long time in the minting of gold coins and jewellery, in addition to as tender and a means of preserving value. The volume of all the gold mined in history is estimated to be 190,000 tonnes, and, at the current price of USD 1,276 per ounce, this means its price is approximately USD 7.8 trillion. For comparison's sake, that is about 8.6 times the market capitalisation of Apple.

Of these 190,000 tonnes, approximately 89,000 tonnes have been turned into jewellery, 40,000 tonnes belong to private investors, 31,000 tonnes to states, and the remainder is held in various other forms. Because gold is practically indestructible, almost all historically mined gold is still in existence. Underground gold reserves (that is to say what has not yet been mined) are estimated at 57,000 tonnes. A quarter of the world's gold is still waiting to be dug out.

Annual gold mining output is currently somewhere between 2,500 and 3,000 tonnes. These numbers from the World Gold Council would seem to indicate that gold mining does not have too long a future ahead and that companies which extract gold will profit greatly from this situation. Does this mean gold miners are good investments? No, they are not.

Let us start with a look to history. Over the past 10 years, the price of gold has increased

by approximately 50%. The price of the GDX, which is the ticker for an ETF copying an index of gold miners (NYSE Arca Gold Miners Index) decreased by 50% in the same period. That is a rather interesting fact: The price of the commodity the companies within the index are mining is rising even as their stock prices are sinking. When we look at the development of share prices for the largest gold miners over the past 7 years, we can see that the price change for only one of them – Rangold Resources – exceeded the rise in the gold price. The price changes of the others not only lag behind the change in the gold price but are deeply negative. The stocks of Eldorado, AngloGold, Kinross, Yamana, and Goldcorp have declined by 60–85%.

Over the past 7 years, the dozen largest gold miners in the market obtained more than USD 40 billion from the market through issuing new shares and partially by issuing further debt. In the same period, only about USD 12 billion was distributed as dividends and the enterprise value of this group of companies decreased by USD 85 billion, predominantly due to asset depreciation. That is essentially an economic loss created over 7 years. This stands in contrast to the amount of USD 550 million that is the sum of remuneration the bosses of these 12 companies received over these past 7 years.

The gold miners' basic problems are chronically low returns on capital and negative

free cash flow. Costs of capital are relatively high for gold miners, because theirs is an industry operating with large investments having time horizons long into the future, there is high debt, the entire industry is exceptionally cyclical, and all the companies are typical “price takers”. Investments made by the majority of miners have returns far below their costs of capital, and so they destroy value instead of creating it. We estimate the average return on capital for the entire group of these companies to be 3%. It is interesting that the market is still willing to finance this sector.

Over the past 7 years, operating cash flow of the big 12 was about USD 100 billion, investments about USD 130 billion, and the increase in debt was USD 30 billion. But the volume of gold production has not changed. The entire sector spends more cash than it takes in, and as a whole its production volume is stagnant. The only miner which does not correspond to this evaluation, as mentioned above, is Rangold. Its returns on capital are above its costs, and therefore there is little wonder that its share price, too, is developing the best among all the other miners.

Is it possible that this situation could change in the future? I highly doubt that. The entire mining industry (together with ocean shipping) is the greatest example of what can be termed an “insiders’ game”. That is a situation wherein insiders – in this case the

companies’ managements – have a large information superiority over the outsiders, which includes shareholders. This information advantage is joined with other characteristics typical of this industry such as giving preference to the volume of mining and other investment projects before creating free cash flow, inappropriate motivation and remuneration for management, and fragmented shareholder structure, the latter of which often includes more speculators than long-term investors. This results in an extraordinary asymmetry between what the companies’ managements take home versus the returns to the shareholders.

People associated with this industry probably will not change. The only thing that could theoretically bring about change is a more active approach by shareholders and pressure on companies’ managements. So far, nothing like this can be seen and therefore it is probable that gold miners’ stocks will continue to be miserable investments also in future. If you believe in gold, then buy gold but not gold miners. If you believe that gold will go down, don’t short gold but instead short the miners. Alternatively, one can go long GLD/short GDX in combination. Or just avoid the whole thing altogether.

The only consistently profitable mining industry is dentistry.

Invest with care!

Daniel Gladiš, 18 November 2017

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The family is the foundation of the company

Among all the stupid communist slogans I used to hear when I was a kid, there was one I liked then and I still like it now: The family is the foundation of the state.

I always believed that families were the basic building blocks of any society, the foundations of education and mutual care. It makes me sorry to see that in the current post-modern society of sharing everything with everyone and unclear gender definitions family is being forgotten. The importance and strength of family can be seen also in the corporate world. Many of history's most successful companies can be called family businesses.

If we define a family business as one where the founders or their direct descendants own at least 20% of the shares or have at least 20% of the votes, then among the best-known publicly traded companies are included, for example, Alphabet, Facebook, Alibaba, Berkshire Hathaway, Samsung, Walmart, BMW, Oracle, Inditex, Heineken, and many others. All of these are very successful companies.

What is more important, however, is that over the long term family businesses fare better than do other companies. Two years ago, Credit Suisse put together data about shareholder returns for approximately 1,000 top companies in the world and determined that over the long term stock returns of family businesses surpass those from the shares of

other companies. The difference for 2006–2015 was 4.5% per year. In ten years, that difference compounds to 55%.

The performance difference is the largest in family companies managed by the first or second generation. In such cases, the difference is about 9% per year. The gap diminishes with each successive generation. The better performance of family businesses is visible in various countries and on various continents as well as in all industries, and it is independent of company size. Moreover, the shares of these companies are not more expensive on average than those of other companies.

Why do family businesses fare better? I would say there may be two reasons. The first one is the thesis that company founders are on average more capable than hired managers. This is quite possible. Establishing a company requires courage, vision, the ability to undertake risk, and certain managerial abilities. Because we only see the ones that succeeded, this sample of people can have really above-average characteristics.

But I think the second reason will be more probable. Family companies as a whole differ from others in their longer-term view, emphasis on financial strength, and their conservative methods of financing and of motivating managers that are closer to shareholders' long-term goals. All this means

that allocating capital – one of the two main tasks of management – is usually more efficient, and in the long view this means faster accumulation of capital and faster growth in company value.

Our own investment experience supports this view. In companies which may be characterized as family businesses we see a truly long-term view and an effort for efficient capital allocation. On the other hand, we have seen the most serious managerial errors in companies with highly dispersed ownership, hired management, and excessive pressure for short-term results.

Today, we have 23 stocks in our portfolio. Twelve of these are companies managed by their founders or their direct descendants. In percentage terms, these account for 52% of our assets. The equities market allows everyone to be a co-shareholder and partner of a family in the diverse offer of family businesses traded on stock exchanges. In this way, an investor can put one's own property into the care of the world's most capable businesspeople and benefit from their abilities over the long term. That is the most beautiful thing about shares.

Invest with care!

Daniel Gladiš, 14 November 2017

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Google or Facebook ?, Part I

There was a time when investors were asking: Coca-Cola or Pepsi? Although I have not heard that in a long time, today I keep hearing instead: "Google or Facebook?" Which of these two companies is a better investment? Let's try to find an answer. (Even though Google is not actually named Google anymore, by the way, no one calls it anything else.)

The key to understanding the two companies is to be clear about what is the main source of their revenue. This year, Google will achieve revenues of approximately USD 108.5 billion. Of this, USD 94.3 billion will be revenues from advertising. Facebook is anticipating total revenues of USD 39.8 billion this year, of which USD 39.2 billion will be from advertising. Advertising revenues therefore constitute 87% of Google's total revenues and 98% of Facebook's. This means that as opposed to the very widely perceived idea that Google and Facebook are technology or software companies, they are in fact advertising companies. This is why the size, growth, and dynamics of the advertising market are decisive for their future growth.

Fortunately, we know quite a lot about that because advertising is an established and well-mapped sector. Global advertising expenditures in 2016 were about USD 580 billion. Over the long term, this number is growing relatively slowly. That rate corresponds very roughly with nominal growth of the world economy, and it also

shows strong cyclicity in periods of recession. This year, total advertising expenses could range around USD 600 billion. As stated above, Google and Facebook together will this year have advertising revenues of USD 133.5 billion and a 22.2% share in the world advertising market. Their share in internet advertising is even greater, at 58.5% of an estimated USD 228 billion.

How high can Google's and Facebook's advertising revenues grow? Let's assume that the growth rate in their advertising revenues over the recent years will continue and that they will double over the next 3 years. In 2020, these would collectively be USD 267 billion, or 39.5% of the global market, the size of which could be USD 675 billion in 2020 (at 4% annual growth). If Google and Facebook were to hold a 60% combined share in internet advertising, then global internet advertising would have to increase to USD 445 billion and its share to 66% from the current 39%.

This scenario cannot be excluded, but it would be very difficult to achieve for several reasons. First, the growth dynamics for Google and Facebook users has slowed substantially. Facebook claims to have 2 billion users. Let's think about that for a moment. The total number of people on the planet with access to the internet is estimated at 3.5 billion. When we subtract states where FB is banned, such as China and Iran, the number of potential FB

users drops to 2.75 billion. Then there are countries such as Russia where a domestic alternative to FB is dominant. This further reduces the potential to 2.6 billion. Of course, we cannot expect that 100% of people with internet access will use FB. Even in the US, this proportion does not exceed 75%. Even in a case that all other countries reached the same penetration (which is very improbable), the global number of FB users would be 1.95 billion. According to its own statements, FB claims to have exceeded that number. So, even if we gloss over the question as to just how reliable is that claim, Facebook is simply running out of people.

Google is in a similar situation. Its reach depends upon the spread of the internet (no radical leaps can be expected) and the availability of Google's services. That availability is frequently limited in various countries, and it is also noteworthy that Google is facing strong local competition in many places around the world. The Czech Republic is a beautiful example of that, and Google itself mentions Seznam.cz in its annual report as an important local competitor.

Another thing that will limit the growth of Google and Facebook is the effectiveness of their advertising. That depends on two things. First, how much advertising it is even possible to press into the users, and second, what advantage it will create for those who are paying for it. The average FB user has a little over 300 friends. This means that FB can place several hundred posts daily from his or her friends and other relevant sources into his or her feed. To this number, we must add the paid posts FB must show to users based on the advertising sold. It is clear that for each

user there exists a maximum quantity of posts that the user is able to perceive. As that level is approached or even exceeded, the advertising becomes ineffective. Google has the same problem, it just looks different on its website.

Doubts have been increasing as to the effectiveness of internet advertising. Especially large companies such as Unilever, Procter & Gamble, and ABInBev, which have advertising budgets measured in the billions of dollars, are finding out how inefficient internet advertising actually is. Here are the words of Marc Pritchard, brand officer at Procter & Gamble: "In our quest to do dynamic, real-time marketing in the digital age, we were producing thousands of ads, posts and tweets because we thought the best way to cut through the clutter was to create more ads. People are voting with their fingertips: they're saying that too much of our advertising is uninteresting, uninspiring, and therefore ineffective. The media supply chain is so murky and non-transparent, and so wasteful and even fraudulent — we're wasting huge amounts of money."

The sister of a friend of mine works in advertising for Danone in New York and indirectly says the same thing: "When we put an ad on TV, we reach the viewer when he or she is relaxed and perceptive, and we always see the impact on our revenues immediately. When we put an ad on the internet, we see nothing."

Warren Buffett frequently says that even among bosses of large companies there sometimes occurs a kind of "group think" whereby one company copies another, with

the main motivation being not to remain on the side lines. Perhaps we are witnessing something similar in internet advertising. Its effectiveness is not clear, and it is possible that this fact will be reflected also in its future growth if advertisers begin to look at it more sceptically.

The following explanation is important for investors. Even if the share of internet advertising grows rapidly and Google and Facebook hold onto their dominant position, sooner or later they will hit the limitation inherent to the advertising market itself. That market will not grow any faster than it otherwise would just so that Google and Facebook can continue their rapid growth. The advertising market will keep growing at its steady rate of around 4% per year in good times and will slow cyclically or even shrink in times of recession. Google and Facebook must eventually demonstrate the same characteristics. They will be slowly growing, cyclical companies. According to the current valuations of the two companies, the market is not yet anticipating that fact. Most investors either do not think about these limitations or believe that this state would occur only far into the future and that there is no need to think about it now.

That is a rather risky game, because the market can change its view of things literally overnight. Once the market stops seeing Google and Facebook as fast-growing

companies without visible limitations and views them instead as slowly growing and cyclical businesses, then their valuations will decrease substantially. If you try to calculate how big the global advertising market would have to be, how large the share of internet advertising within it, and the share of Google and Facebook within that, you will find that even an ideal combination of these three factors may not be sufficient to justify the current market capitalizations of the two companies – and that is especially true for FB.

I think we can find a lot of better investments, but if I had to choose just between these two companies, I would choose Google. The only way to get out of the advertising market straightjacket is to develop another business with a comparable impact on profit. Google is closer to doing that. Its business is more robust and more diversified than is that of FB. This is no simple task, however. History shows that developing a strong and profitable “Act 2” is very difficult. Microsoft has never had a product financially comparable to Windows and Office. Apple has nothing that could make as much money as iPhone. And that is the case even though both those companies had and still have practically unlimited resources to come up with something. There are plenty of similar examples. This is one of the reasons why it would be very difficult for Google and Facebook to come with something the profitability of which could compete with that of their current businesses.

Invest with care!

Daniel Gladiš, 15 October 2017

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Google or Facebook ?, Part II

In our previous essay, we pondered whether Google or Facebook is the better investment. Our arguments were based mainly on numbers related to the size and growth of the advertising market and the positions and prospects of the two companies within that market.

Investing, however, is usually not only about numbers. While numbers are of course important, it is good to complement them with a deeper look into the story relating to any particular company. We'll endeavour to do that in this second part.

Let's begin with a look at Facebook's mission statement. It states the following: "Give people the power to build community and bring the world closer together." That sounds very nice. At least until the instant we confront this statement with reality, because reality is diametrically different. The mission statement implies that Facebook endeavours to bring good to its users and tries to make the impression that they are the company's customer. In fact, Facebook is doing something completely different. It monitors its users literally at every step, collecting various data about them, their behaviour, and all possible forms of their private data – all of which it sells to advertisers. Facebook users are therefore not clients at all but the company's product. I have tried in vain to find another important company with a similarly great disparity between what the company

declares to be its mission and what it is doing in fact.

What is Google's mission statement? It is this: "to organize the world's information and make it universally accessible and useful." Google is similar to Facebook in how it collects and handles data on its users. The difference lies in

Google's greater awareness of this disparity and of the moral ambiguities involved, and it bears these facts in mind – at least a little – in how it conducts its activities. In addition, it cannot be denied that Google does in fact "organize the world's information and make it universally accessible and useful". Its business has a much greater added value than does Facebook's.

Despite all Facebook's proclamations about connecting people and creating communities, it is an advertising company plain and simple. This is no new discovery, of course, but it would interest us to know how many people in fact recognise that. Facebook users feed the company's database with unbelievable amounts of data at no charge. Facebook is vitally dependent on them, because they are the source of all its revenues. What would happen if people would stop using Facebook?

This may sound like science fiction, but history has known a number of similar cases. What if people start to become tired of Facebook and at the same time begin to realise more the

actual nature of its business? Can people be kept satisfied indefinitely knowing that they are constantly being monitored and their life is, metaphorically speaking, for sale? Facebook presently has nothing to fall back on if people were to stop using it. From this viewpoint, Google's business is much more robust and resilient.

The businesses of the two companies also have other impacts that may in future be a source of existential challenges. We will mention the two most serious ones. The first one is distortion of reality. What is that about?

If you want to learn something from the world, something about current events, or if you are just looking for some information, you will very probably use Google or Facebook. What you see, however, is not objective reality but just something Google and Facebook want you to see. And this difference between reality and what you are provided can sometimes be very great. Google and Facebook have various motivations, and these sometimes are in conflict with one another. On the one hand, they want the things you see to be high-quality content because they should have an interest to provide high-quality services. At the same time, however, they want to target the specific interests and preferences of each individual user, and that necessarily deforms what is presented to us. In addition, they must of course satisfy the demands of their advertisers, and then we come to their own internal censorship and the interest to shape public opinion, which we definitely should not underestimate.

For example, we know that Google and FB live off internet advertising. Do you think the posts

and articles supporting the advantages of internet advertising are displayed objectively or is there some partiality and therefore manipulating of public opinion? Take another example: What if Mark Zuckerberg decides to get into politics? Would FB be objective or would it support him with a skewed post selection algorithm? And what if Google's founders would not want him to succeed? Would they modify their algorithm too? We do not know the answers and it is a scary idea.

The result of all this is that we are presented with a skewed image of the world and we are unable to judge the extent of that deformation. In a situation of duopoly with two dominant companies in internet advertising, there is also a duopoly of information handling. A second negative impact caused by the two companies goes hand in hand with this. Internet advertising already has killed off a large part of printed news media, thereby causing the quality of journalism to be diminished along with that of general debate in society. When we again compare the two companies, due to Facebook's susceptibility to abuse and its almost complete indifference to this problem, it comes off looking far worse than does Google. (And I am very well aware of the paradox that I am publishing this text on FB.)

This is why both companies will probably be more and more targeted by various regulations and limitations. After all, this has been going on for some time already. The regulators are gradually beginning to realise that there is not only a duopoly of two dominant advertising companies but also a duopoly concerning the management of information flows. The first indications of

regulatory pressure began to appear several years ago in the areas of taxation and handling of information. Apparently this is just the beginning of a long-term trend. In this regard, Facebook is certainly more vulnerable than is Google.

As we set out to explain in the first part of this discussion, it is unavoidable that sooner or later Google and Facebook will come up against the limitations defined by the size of the global advertising market and their growth will slow substantially. This slowing will probably be much more apparent and also more surprising in the case of Facebook. Both companies can be expected to come under pressure, and it is possible that this will lead to an even stronger tendency to manipulate the public and even greater exploitation of users' personal data. While Google will be far from immune to this pressure, what Facebook might do is much more to be feared.

We also must not forget a long-term problem in the corporate governance of the two companies. They both have several asset

classes such that the shares owned by the founders have more voting rights than do those of the other shareholders. As long as the two companies are doing well, investors will in some measure tolerate that situation. As soon as a period of adversity comes along, however, this very probably will become a source of conflict between the founders and other shareholders.

When we look at the historic development of the two companies' share prices, many people will ask why we should concern ourselves with such nonsense when the share prices of the two companies keep rising? A rising share price does not, however, mean that everything is okay. The rising share prices of the two companies, and especially of Facebook, reflect very optimistic views about the two companies and their futures. This is why it makes sense to think about the future from various perspectives. Google emerges from our deliberation looking better from almost every angle, and if the question were to be "Google or Facebook?", our answer would be "Google".

Invest with care!

Daniel Gladiš, 22 October 2017

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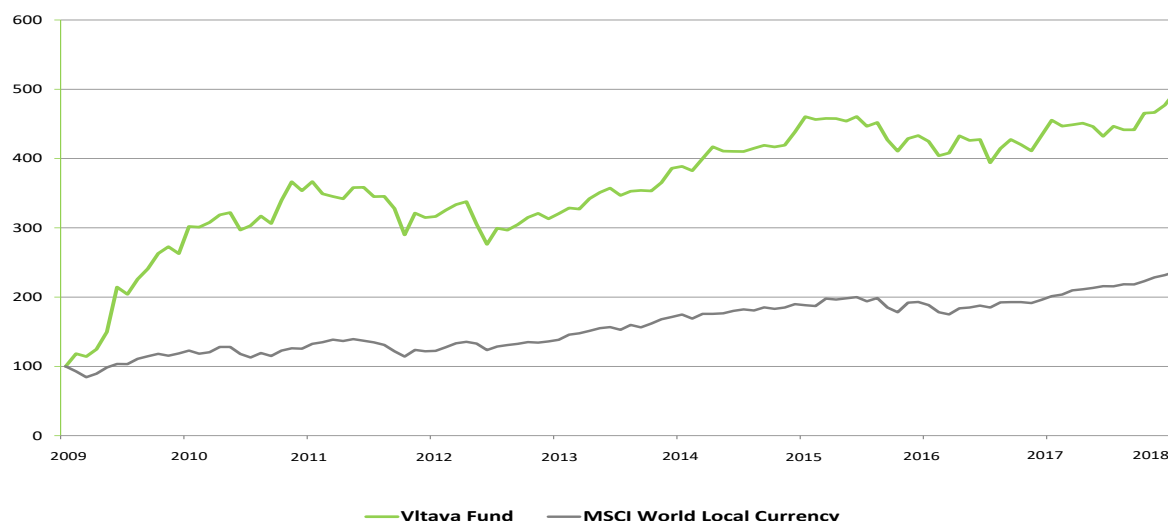
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PORTFOLIO PERFORMANCE AND COMPOSITION

To evaluate the results of our current investment strategy, the Fund's board of directors uses the following graph.



This graph compares the development of the Fund's NAV with the development of world equity markets as represented by the MSCI World Index for the entire period in which we were following the current investment strategy. That mean for the nine years since the beginning of 2009.

As can be seen in the graph, the Fund's NAV increased over the full period by 397 %*. World equity markets grew by 134 % for the same period. *

Even though comparing the Fund's returns with indices may seem like a good idea, it is always necessary to be mindful of this method's limitations. In our case, there are specifically these qualifications:

1. It is not our objective to beat any specific index, and any comparison with an index for global equity markets only helps to paint a certain picture of the results under our current investment strategy.
2. Comparisons with the index do not at all take into account the Fund's risk level. In our case, this is much lower than the risk of the market as a whole.
3. If we do make such a comparison, it is necessary to do so for a period corresponding to the Fund's investment horizon. In our case, this is a minimum of five years. Any shorter period has practically no information value. This is due to two reasons: The first reason is that we set no short-term objectives. Our strategy is a long-term one, and we do not try to achieve certain results within short-term

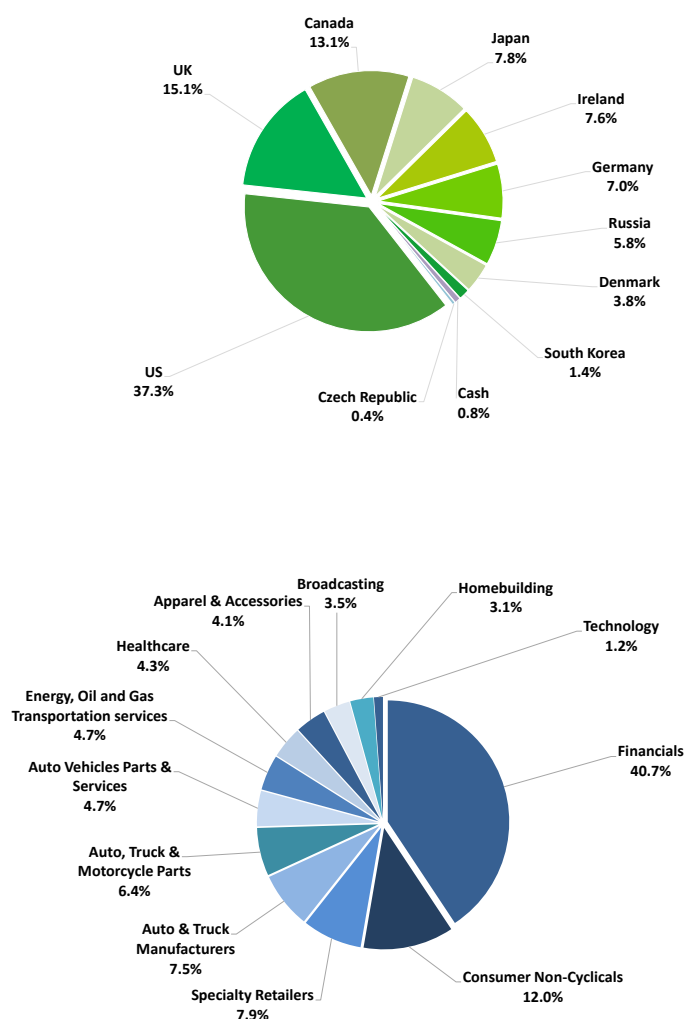
*Footnotes:

1. Data as at 31 December 2017, 2. The MSCI World Index is calculated in local currencies, 3. Information concerning the investment strategy during 2004–2008, returns, and the change to the present investment strategy can be found in letters to shareholders and annual reports.

horizons of less than three years. The second reason is that our strategy is founded on a concentrated portfolio of selected, attractive investments. There are 22 such investments today, and the 10 largest ones account for approximately 65% of the portfolio. In shorter periods, portfolio returns must always diverge from those of the equities markets as a whole, and in both directions.

4. The Fund's NAV is calculated in Czech crowns while the MCSI World Index is calculated in the local currencies of the individual countries. If the returns of this index were converted to crowns and the Fund's costs for currency hedging were taken into account, the difference between the returns of Vltava Fund and those of the index would be still greater.

Vltava Fund's current portfolio is distributed as follows:



*Footnotes:

1. Data as at 31 December 2017, 2. The MSCI World Index is calculated in local currencies, 3. Information concerning the investment strategy during 2004–2008, returns, and the change to the present investment strategy can be found in letters to shareholders and annual reports.



PERFORMANCE OF THE VLTAVA FUND PORTFOLIO

Dear Shareholders,

we stand at the close of another year, and, instead of presenting a more general topic in this letter to shareholders, now is a good time to look once again, after several years, at the historical performance of the Vltava Fund portfolio. Let us take it from the beginning.

Prehistory

We established the Fund a long 14 years ago. Back then, we were young and ambitious, and this was reflected also in the investment strategy with which we started out. Our initial assumption was that we would be able to pick stocks the returns from which, over the long term, would substantially exceed those from the market as a whole, and we intended to build upon that. We were not satisfied with just this simple approach, however, but endeavoured to come up with a structure that would in its overall effect reduce our dependence on market returns and increase the impact of our individual stocks selection.

We came up with the idea that if we would combine with our long-positions portfolio a short position in the index for the entire market and then use the cash thereby obtained to double our long positions, then the influence of our stock picking on the Fund's return would double and the dependence on equity market movements would be relatively reduced.

We knew that the success of this strategy would depend upon two conditions: First, that we truly could pick stocks which would beat the market, and second, that we would be able to hold our positions for as long as necessary. The first condition was never a problem, but the second one was.

Initially, all went well. In the first three years and four months, that is from September 2004 to the end of 2007, our return was 85% while the return of the global equity markets (MSCI World Index) was 44%. Then came 2008, however, and along with it extreme dislocations in the markets and chaotic behaviour of equity prices.

A sharp drop in equity markets in 2008 brought great losses to most investors. This in and of itself would not have been a reason to change the Fund's investment strategy. Markets do drop sharply from time to time, and that is to be expected, and this is always just a transient phenomenon. The problem we were facing was record-setting price volatility and chaos on the markets.

In autumn of 2008, when the financial crisis was at its worst, regulators began increasingly to intervene in market operations. For example, they prohibited the shorting of certain stocks. This caused great chaos and closing of positions and, among other things, a steep rise in share prices even of companies which should have feared for their very survival (and some of which later did go



bankrupt). Insufficient liquidity in the markets created a hunger for cash, and the source of needed liquidity became liquid stocks with no regard for their fundamentals. By contrast, other, less-liquid stocks took a hard hit. This was reflected in the VIX volatility index, for example, which spiked to an incredibly high 80 points. VIX values in the range of 15–20 are more usual.

We could continue to cite anomalies at great length. In short, the effect was that the long positions in our portfolio were sharply declining for some time even as the short positions were rising sharply. Such combination very quickly slashes the Fund's assets and, most importantly, rapidly increases the financial leverage, which is expressed as a ratio of all positions relative to the Fund's equity capital. One cannot just stand by and watch this impassively. Instead, the increasing risk must be managed in a certain way. In our case, this meant selling long positions and buying back short ones. As you can imagine, the prices were not advantageous for such operations and the feeling was as if we were cutting into our own living flesh.

Then what?

The second condition, the possibility of holding positions for an unlimited time, was therefore breached. At the end of 2008, we faced a decision what to do next concerning our investment strategy. It was clear to us that we would abandon the strategy which to a large extent involved combining long and short positions. At the same time, we knew this was not an error in the investment philosophy itself or in the selection of the individual stocks, but rather a conceptual

error caused perhaps by an effort to make money for our shareholders too quickly.

We considered two options. One of them was to formally close down the Fund and open a new one. The second was to continue with the same fund, even with the knowledge that the investment strategy into which we switched in early 2009 would be so diametrically different from the previous one that the Fund's historic performance would in fact consist of two separate periods and two wholly unrelated strategies.

In the end, we decided to continue with the Fund. We did not want by closing the old fund and opening a new one to create an impression as if the first years of the results were not attributable to us. The main reason, however, was a clear wish among all of our shareholders at that time for us to continue with the same fund. When we saw that all the shareholders at the time were remaining invested in the Fund, and that some of them even were increasing their investments, there was nothing more to equivocate over. Nevertheless, the Fund's name and the valuable lessons learned are today the only things that join these entirely different stages and strategies to one another.

A new beginning

It was easy transitioning the Fund over to the new strategy. The selection of stocks for the portfolio did not change; we only abandoned the large combination of long and short positions. We therefore entered 2009 with an approach whereby complexity was replaced with simplicity. This may seem trivial, but it is an entirely different investment strategy. It is like the difference between tennis and table tennis. Both are played by hitting a ball over a

net, both names include the word tennis, but they are two entirely different sports.

With the new investment strategy, it cannot occur that some situation in the market will compel changes in the portfolio. Our strategy is a long-term one, and therefore it still is founded on the possibility of holding the individual stocks for as long as necessary. Without financial leverage, this possibility is threatened by nothing. We therefore can focus fully on what creates the greatest added value for our shareholders, which means picking individual stocks.

This had never been a problem in and of itself. Even the year 2009 shows, for example, that our result for 2008 was really caused by the reasons described above, and not by poor stocks selection. In 2009, we achieved a return of 201% (the equity markets just 22%), while our equity portfolio in early 2009 was the same as that at the close of 2008. Changing the investment strategy was the right decision, and we will stick to our current strategy also into the future.

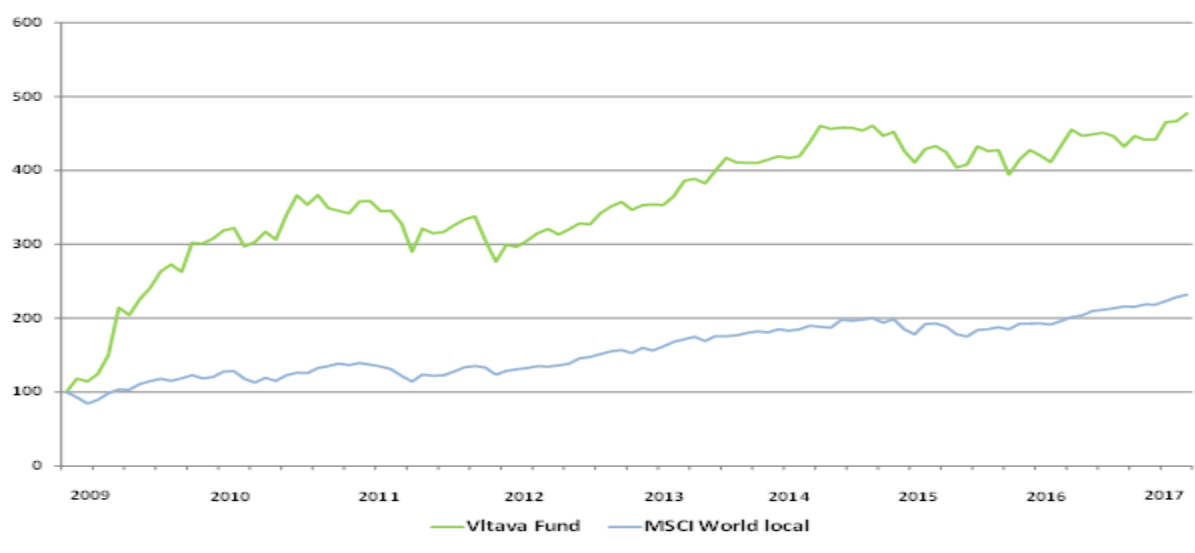
Results of the current investment strategy

When we assess the results of our current

investment strategy, we use the following graph.

This graph compares the development of the Fund's NAV with the development of world equity markets as represented by the MSCI World Index for the entire period in which we were following the current investment strategy, that is for the nine years since the beginning of 2009. The graph's point of origin is not selected at random. Rather, it is the point in time when we abandoned the original investment strategy and switched to our current one. This comparison is also relevant for contemplating future returns, because we do not intend to change anything about the current investment strategy, and our previous strategy does not relate in any way to the future. In considering comparisons with the market, our fund is a global one, and this is why a comparison with a global equities index such as MSCI World is necessary.

The graph indicates that the Fund's NAV increased over the entire period by almost 5 times or, more precisely, by 397 %. World equity markets grew by 134 % for the same period. Although it is not our objective to beat any specific index, this nevertheless helps to paint a certain picture of our results. In any



case, it is necessary to make the comparison for at least five years, as it has practically no informative value over a shorter period. This is due to two reasons: The first reason is that we set no short-term objectives. Our strategy is a long-term one, and we do not try to achieve certain results within short-term horizons of less than three years. The second reason is that our strategy is founded on a concentrated portfolio of selected, attractive investments. There are 22 such investments today, and the 10 largest ones account for approximately 65% of the portfolio. In shorter periods, portfolio returns must always diverge from those of the equities markets as a whole, and in both directions.

Over those long nine years, we bought shares in 71 different titles. The portfolio's turnover was higher during 2009–2011 because it was necessary to respond quickly to rapidly changing equity prices. In the following years, the turnover gradually came down. Out of the 71 stocks acquired, we have already sold 49 and are currently holding 22. Of the 49 stocks sold, we realised gains from 44 stocks and lost money on 5 stocks. Of the 22 stocks we are still holding, we are in positive-returns territory in 20 cases and in negative returns in 2 cases. Our history to date thus shows that we are making money on approximately 9 stocks out of every 10 we buy. We presume this will be similar also in future.

Sometimes a person takes a misstep, but that is not something one can always avoid. The important thing, however, is that we did not lose much on those few stocks we closed out at a loss. Our longest-held stock is Total Produce, and the earnings we have from that are greater than the losses of the seven losing stocks put together. By the way, Total Produce

was the first stock upon which we made a tenfold return. Of all stocks sold, we recorded the greatest loss in percentage terms on Bed Bath and Beyond (–30%) and the greatest profit on preferred shares of Fannie Mae (+376%). In certain of the stocks currently held, we have even higher gains.

Striving for constant improvement

The crux of our work today is in seeking out high-quality companies that are run by their managers in the best interests of shareholders, and especially in buying them at attractive prices. We are constantly striving to improve the definition of what we consider to be a high-quality company, and therefore we have gradually moved most of our investments to developed markets. The level of corporate governance – which refers to those mechanisms, processes, and relationships that are ongoing in managing a company – are very important for us. We are essentially very conservative investors and do not like to undertake unnecessary risks.

Our view as to what we regard as a high-quality company has also been developing over time. In the past, we considered it sufficient if we believed that a company has a certain sustainable competitive advantage. Today, we consider it more important whether a company is working to strengthen and enhance that advantage. We also put greater emphasis than before on company management and culture. Perhaps corporate culture is the most valuable competitive advantage, and yet it is very difficult to discern. It is no accident that more than half of our portfolio is comprised of companies managed by their founders or their direct descendants.

Our view of risk has developed similarly. The older we are, the more emphasis we put on the correct definition of risk and its management. This is not a completely straightforward matter. There exists no generally used definition of risk, risk is not measurable, and it is highly subjective. We occupy ourselves more and more in addressing this indispensable aspect of investing. Every human activity involves risk, and investing is of course no exception. We do not mind undertaking risks, but we want to have our own clear definition of risk, so that we can be compensated for it with sufficiently large returns.

Our work involves evaluating a set of approximately 2500 companies from all around the world. Among these, we progressively seek out those where we feel we understand what they do, those which have some sustainable competitive advantage, and those which are managed in the interests of shareholders. Only then do we attempt to estimate the value of each of these companies. Most of them are too expensive according to our measures most of the time. We therefore wait patiently for individual companies to reach advantageous prices. If and when this occurs, then we can consider including them into our portfolio.

Changes in the portfolio

We sold the shares of Proxima. It was our smallest position. The company has recently been gradually changing the focus of its activities in a manner that was not in accord with our thinking. Our profit was 6%.

On the other hand, two new positions have been added to the portfolio. One is in South Korea and the other in the UK.

South Korea is by no means an unknown country for us. We have had two investments there previously and were very satisfied with both. The Korean market has been among the least expensive for a long time. This is a price that South Korea pays for the frequently weaker level of corporate governance in Korean companies. In some cases, however, the situation is substantially better and the market frequently does not take that fully into account in the pricing of these stocks.

Our new position is in the technology sector. When several years ago we visited the managements of several companies in Korea whose stocks we were following, we could see at every turn that Korea is a country where the people literally live by technology and electronics. It is no accident that Korea ranks number-one in the world for the number of patent registrations per inhabitant. Several Korean technology companies are among the world's best, and we now own one of them.

Our new British company is active in the financial services sector. Here we faced a dilemma: This is a relatively small company, also partially owned by the founder's family. That means we will not manage to buy enough stock to form a typical 5% share in our portfolio. We do not want to have too many individual positions in our portfolio, so we pondered whether it makes sense to buy. In the end, we decided to start buying the shares, even with the knowledge that it will be a small position. This is because we historically have achieved the highest percentage earnings on smaller and medium-sized companies, and every crown counts.

The past nine years have been rather favourable for stocks. The markets have been



rising at an above-average pace, and it is easier to make money in such an environment. We have no idea what the next nine years will bring. We estimate, however, that our earnings as well as the earnings of the global equity markets will be somewhat lower than those in the past nine years. Their returns, however, will very probably continue to exceed those of the other basic asset classes.

Today, our portfolio is valued at approximately 12 times the earnings achieved in the past year. Paying low prices for select stocks is the basis of our investment philosophy and the basis of our risk management. Price always has a large influence on the amount of investment risk, and the lower the price the lower the risk. We have therefore recently been avoiding popular, rapidly rising, but predominantly very expensive large US stocks. It is currently very difficult to find an attractive investment on the US market. This is why we have been buying on other markets in the past year – in Denmark, Canada, Japan, the UK, and Korea. These markets are much less expensive, their asset prices are not deformed by passive investing into indices, and one can invest well on such markets. A time when more and more investors are jumping onto a running train and buying index funds like crazy is a golden era for active investing. What could be better than a situation wherein more and more market

participants are not concerning themselves at all with the pricing of individual stocks?

Our estimate of Vltava Fund's fundamental value is 17% higher than the Fund's current NAV, and for the next three years we expect it to grow by 10% per year. This would mean that at the end of 2020 the portfolio's fundamental value could be about 50% higher than today's NAV. Essentially three things influence the development of the portfolio's fundamental value. First, our estimates as to the fundamental values of the individual companies. Second, the passage of time itself, because a company's fundamental value develops over time and has a strong tendency to grow as more and more capital is earned and then reinvested. Third, our transactions through which we replace lower-potential companies with those having higher potential. The prices of individual stocks are something we cannot influence, but we can influence their selection, and that is what we fully focus upon. Long-term growth in the fundamental values of well-selected stocks will also pull up their prices. That is one of the few things that a person can rely upon.

On behalf of all of us, I wish you a peaceful and pleasant new year.

Daniel Gladiš, January 2018



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WHEN WE SAY EARNINGS

Dear shareholders,

Three investors were sitting in a pub, arguing over how expensive the US equity market is. The first one asserted that the S&P 500 was trading at 24 times earnings per share – that is to say with a P/E of 24. The second claimed that the P/E was 21.6, and the third investor said the P/E was 17.3. All three had based their assessments on the same source – official data from Standard & Poor's. How is it possible that their numbers were so different? It is because each was using a different definition of earnings per share. All three were correct, but each was speaking about something different.

This might have sounded strange to somebody casually passing by. After all, earnings are earnings, right? But it is not quite so straightforward in finance and investment. When we say earnings, this can be understood variously and so it is necessary to specify which earnings we have in mind. Earnings per share can essentially be categorised in two ways: first on a time basis into actual, historical earnings and future expected earnings and second according to how they are calculated.

The first investor, who stated that the market was trading at 24 times earnings per share (EPS), was referring to historical earnings – the actual earnings achieved over the past 12 months and calculated according to GAAP (Generally Accepted Accounting Principles).

These earnings are of a high quality because they are real, and therefore not an estimate, and they are calculated in accordance with unified accounting rules. The second investor also was talking about historical earnings actually reported, but these had not been calculated in accordance with GAAP. Rather, they had been adjusted (one might say “enhanced”) by the individual companies’ managements. So, what does that mean?

Non-GAAP earnings

In recent years, the managements of US companies have increasingly preferred to report their own, adjusted, non-GAAP earnings rather than those calculated according to GAAP. They use various terms for these earnings, such as adjusted earnings, operating earnings, core earnings, pro forma earnings, earnings ex certain items, etc. Such reported earnings have one thing in common: They exclude items prescribed by GAAP and include items prohibited by GAAP. The managements assert that such adjusted earnings more precisely reflect the actual profitability of their companies. It is interesting that these earnings almost always turn out to be much better than GAAP profits, and quite markedly so. Most probably, the motivation for these corporate managements is something other than an endeavour to provide a more perfect accounting.

According to various studies and statistical data, non-GAAP earnings reported by US



companies in recent years have been fully 22% higher than their earnings calculated pursuant to GAAP. That is an immense difference. For individual companies, the differences are often even much greater. Every investor who wants to value publicly traded companies must know about this problem and know how to deal with it.

The most frequently encountered and largest items where GAAP and non-GAAP numbers differ are one-off depreciation of assets and one-off amortisation events. If a company suddenly writes off a chunk of its own assets, it either is admitting that its historical earnings were overstated (because its stated depreciation was too low in previous years) or it is promising that its future earnings will be overstated (because the large one-off write-down of assets will reduce ongoing depreciation long into the future).

Other items frequently tucked into non-GAAP statements are costs related to acquisitions and restructuring costs. Companies often present these as one-off items that should not be taken into consideration, even though they recur in the statements year after year.

My “favourite” item, which is widely used especially among companies in the technology sector, is remuneration to employees paid in company stock. The companies issue new shares and give them to employees in place of salaries. Because these are not cash payments, the companies imply that these are not costs at all, which is just plain ludicrous. And we are not talking about small change here, either, but rather large sums. Here is a beautiful example from the accounting of the company Splunk:

Last year, Splunk recorded revenues of USD 950 million. This may be the only number upon which the management and we agree. In its non-GAAP results, Splunk states that its net earnings were USD 55 million for last year. The company’s GAAP accounting, however, reports a loss of USD 355 million. The vast majority of the difference is due to salaries paid in the form of shares – a whopping USD 378 million. Now, losing USD 355 million on revenues of USD 950 million is a very bad result. The management, however, seems satisfied and is proud of its own tailor-made bottom line presenting Splunk as a profitable company.

The crucial problem with non-GAAP earnings is that to a large degree they are a product of the respective management’s own creativity. Then too, of course, they also are unaudited, provide investors with distorted information, and make comparing individual companies much more difficult. Such earnings data are therefore of low quality and unsatisfactory in their representativeness. The second of our three investors in the pub was using this type of earnings. He is free to do so, of course, but he should be aware of what he is doing. The third investor took an even more aggressive approach and used non-GAAP expected earnings for the coming year. Here, we are very much skating on thin ice. Working with earnings data that is of low quality to begin with and then made even more imprecise by the element of future forecasting is quite foolhardy on the part of the investor. Nevertheless, such numbers are actually being used. When people take such enhanced non-GAAP earnings still further overstated by typically overly optimistic future projections,



then they come to a high EPS number which, being the denominator in the P/E calculation, makes the overall market appear to be much cheaper.

Beware of comparing the incomparable

If we consider the dearness of the market as a whole – for example, relative to historical averages – we must always be mindful of which earnings we are using in our calculations to avoid comparing apples and oranges. The GAAP EPS figure for all companies in the S&P 500 as of this past June was \$104. The index's P/E is therefore 24.1. The average for this indicator over the past 70 years was 17.5. By this comparative measure, the US market is expensive. Non-GAAP earnings (operating profit) achieved over the past 12 months were \$115.90. This would mean a P/E of 21.6. Now, this P/E must only be compared with the historical average based also upon non-GAAP earnings. In recent years, non-GAAP earnings have been approximately 15% higher than GAAP earnings, which would put that average historical P/E around 15. By this measure, too, the market currently looks expensive.

If analysts or commentators want to persuade others that the market is cheap, they often take forecast non-GAAP earnings for the coming year and compare them to the average calculated on the basis of actual GAAP earnings. Taking today's situation as a concrete example, it would look like the following: The 2018 forecast non-GAAP EPS for companies in the S&P 500 is presently \$144.7. This gives a P/E of 17.3, which is slightly lower than the historical average P/E for the market (17.5). Thus (one might argue),

the market is not expensive at all. In fact, however, if the market were to be trading somewhere around its long-term average P/E as calculated according to estimated non-GAAP earnings for the next year, that P/E would have to be approximately 12.5.

So, if someone says that the market is on the whole expensive, that person should clearly state with which earnings he or she is working and with which long-term average the comparison is being made. It is not difficult to orient oneself with these numbers; a person just needs to be attentive to the details. It is much more difficult, however, to make sense of the numbers reported by individual companies. Our investing is founded upon selecting individual stocks and in analysing them. To achieve that in practice, over time we have established the following internal rules:

1. We never automatically accept numbers as they are presented to us but instead approach them with a healthy dose of scepticism.
2. We are aware that company managements have various motivations and that we must consider any given company's overall culture. If we fail to understand the presented financial statements of a certain company, it is often because the management does not want anyone to understand them.
3. We unequivocally prefer GAAP numbers to various non-GAAP adjustments. Even though GAAP is an imperfect set of accounting standards, it is universally known and is the same for all companies. If we feel that GAAP statements require some adjustment



in order to provide a more accurate picture of a company's operations, then we make such adjustment ourselves. This is also very important when comparing individual companies to one another.

4. We place greater importance on free cash flow than on earnings, because this indicator is harder to manipulate and is crucial for a company's valuation.

All this is rather labour-intensive, but no one can expect to make big money in the equity markets without putting in the work.

Adjusted REBITDAR

The managements of a number of companies try to divert attention away from the fact that their companies are doing poorly in terms of profitability and to persuade investors (and bankers) that other lines higher up in the income statement are more important than is the bottom line. At some point in the past, the concept and abbreviation EBIT (earnings before interest and tax) first came into use. It was supposed to demonstrate better a company's ability to generate the cash flow necessary to service its own debt. It has become apparent, though, that this figure does not fulfil its purpose very well because both interest payments and taxes are real and often very substantial costs.

Nevertheless, EBIT is under normal circumstances higher than is net profit and so it has a certain enticing appeal. This indicator is not only still in use but it has been augmented with two additional items: depreciation and amortisation. The argument was made that depreciation and amortisation

are noncash items and therefore can be ignored. Even though anyone who has ever managed a company knows that depreciation is a very real business expense, such protests were swept aside. The new indicator thus became known as EBITDA (earnings before interest, tax, depreciation and amortisation). Buffett's partner Charlie Munger, who never shies away from using colourful language when it is properly descriptive, refers to EBITDA as "bullshit earnings". And he is right.

But the accounting creativity does not stop there. You may sometimes come across the abbreviation EBITDAR. The R at the end stands for rent, and EBITDAR is often used in relation to retail chains where it entails costs for leasing retailing premises. Some take this even further and present their results as REBITDAR, which stands for recurring EBITDAR. But the gold medal must go to an accounting line item termed Adjusted REBITDAR, which is adjusted recurring earnings before interest, tax, depreciation, amortization and rent. Such item tells us essentially nothing about the company and its value. In terms of cooking the accounting numbers, it comes in just a smidgeon short of what we might call EBE (earnings before expenses). I think it is just a matter of time before we will see that, too.

So how expensive are the markets?

I very often hear that the markets are expensive. The word "markets" nearly always is intended to mean the US market, as if other markets did not even exist. The US market truly is expensive. According to most basic indicators, it is above the 90th percentile of its expensiveness, meaning that in less than 10% of its history has it been pricier than it is right



now. Its fair value could be some 20–25% lower. But this in and of itself says nothing about how the market will develop going forward. It can continue to rise and remain expensive for a number of years to come. It may move sideways and gradually become less expensive as the earnings of US companies grow and catch up to the overstated price multiples. And, of course, its expensiveness might be corrected more quickly by a dramatic drop. We cannot say which of these is the most likely, but we certainly can say that neither is the market a bubble waiting to burst. In any case, though, the situation urges caution, and therefore our net exposure to the US market is only 28% of the entire portfolio.

There are nevertheless many more markets on our planet that do offer good investment opportunities. Europe, the second-largest market, is substantially less expensive than is the US market, and we also regard the Japanese market to be inexpensive. An investor is currently much safer to be active in these markets. It is interesting that in Europe, and particularly so in Japan, the manipulation of financial statements is not as widespread as in the US. I would say this relates to those markets being less expensive and so managements of companies in those environments are under much less pressure to demonstrate good short-term results.

The dearness of entire markets affects us as active managers only indirectly. One can always find attractive opportunities; it just demands more effort in expensive markets. Our current portfolio is valued at approximately 11 times actual, historical

earnings (as we ourselves have adjusted them). This means that the multiples of earnings we pay for our equities are about half those of the US market. But that's not all. The companies we hold are above average in terms of the quality of their businesses. That quality is reflected in the combination that is the types of business, market positions, financial soundness (meaning low debt), and managerial and business cultures of those companies. The portfolio is not just inexpensive as a whole, but so, too, is each individual share. All the companies in our portfolio are highly and regularly profitable over the long term.

Such companies are not easy to find. They are not offered on every street corner, but they do exist and the role of active investors is to select the best among them. Investors most frequently talk about the returns from individual stocks (or even entire markets), but they forget about the other side of the same coin, which is risk. Our portfolio is not only lower-cost than the market but also much less risky. The low level of risk is due to both the valuations of the individual stocks (their price-to-value ratio) and the quality of the underlying businesses.

Changes in the portfolio

We sold Irish Continental Group. We had bought this shipping company last year in July, just after Brexit. At the end of June last year, the UK equities market and a number of stocks of other companies doing business in the UK had gone through a period of panic selling by investors who had considered Brexit to be just about the end of the world. I remember well how at the time we were



looking with disbelief at the prices of some stocks and contemplating which to buy first. One of our purchases was ICG. About a year later, we decided to sell the shares with a gain of 35% because it seemed to us that our investment thesis had been fulfilled and the shares were no longer priced attractively.

We put the funds that were freed up into another company, coincidentally also involved in shipping – albeit on the other side of the world and with different types of cargo. We

have had this company in our portfolio previously, back in 2004–2007, so it is no mystery to us. This business is outside the main interest of investors and the main indices. Furthermore, this company constitutes a special situation that we think the market is evaluating entirely incorrectly. Every time I have explained this investment to one of our shareholders, the reaction has always been the same: buy as much as you can get! I can now report: mission accomplished. 😊

Daniel Gladiš, October 2017

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INDICES AND INDEX INVESTING

Dear shareholders,

We are witnessing today a trend of investors massively moving their money from actively managed funds into passively managed funds, also known as index funds. The active-versus-passive debate is not new. It has been periodically recurring for decades, with each party alternating in dominance. Just now, it seems that passive investing is winning and the trend of shifting money into passive funds has in fact accelerated in recent years. What does this mean for us? Should we jump onto the bandwagon or should we instead take advantage of opportunities to which this trend gives rise? This letter is all about answering that question. Let's begin by looking at some numbers. We will focus mostly on the US market, because that is where this trend has advanced furthest.

Money flows into index funds

Index funds endeavour to mirror the returns of a certain basket of equities or of an index. This is not at all a new product, but it has witnessed a real upsurge in recent years. According to Credit Suisse, the sum of money invested in US investment funds rose from USD 287 billion in 1989 to USD 8.7 trillion at the end of 2016. Over the same period, the volume of money in index funds increased from USD 3 billion to USD 2 trillion, and it

doubled in just the past 4 years. In 1989, index funds accounted for approximately 1% of the market, but today they account for 23% of assets under management in investment funds. In the last ten years, USD 1.2 trillion flowed out of actively managed funds and USD 1.4 trillion flowed into index funds.

This unprecedented movement of money is deforming the market, changing its dynamics, and bringing both immense risks and opportunities. Before we get to those, let's take a look at how indices are actually created.

How indices are created

We'll take as an example a broad and most widely used index, the S&P 500. This is composed of the 500 leading US companies, which together represent approximately 80% of the entire US stock market. Individual companies are represented within the index in proportion to their market capitalisations. The largest weight goes to Apple, whose market cap is approximately USD 800 billion, whereas the smallest company in the index has a capitalisation of USD 2.7 billion. The ten largest companies account for 19.1% of the entire index.

Very important, however, is that the index's composition is not permanent. Rather, it changes almost constantly. The weights of the



individual companies in the index are continuously adjusted in accordance with changes in their market capitalisations. The more a share increases in price, the greater its weight within the index. A greater weight in the index means that more money flowing into the relevant index fund is directed to that stock. This brings us to the first important point: The more expensive a share is, the more money that flows into it. I call this the perverse cycle of index investing. When a share is rising in price, its weight within the index grows, which means more money passively invested into the index is allocated to it, which causes its price to rise even more, its weight in the index further increases, and thus it attracts even more money. The cycle is a closed one and feeds upon itself like some kind of perpetual motion machine. This simultaneously means that money tends to flow away from shares which are becoming steadily cheaper.

GM vs. Tesla

You will surely remember that at our last annual shareholders' meeting we were discussing the valuation of two car manufacturing companies – GM and Tesla. At that time, they had approximately the same market capitalisation of USD 50 billion. We took a little survey then. An investor has USD 50 billion at his or her disposal and must choose whether to buy the entirety of GM or the entirety of Tesla. The investor who chooses GM can expect to obtain USD 9 billion in profit at the end of the year, whereas the investor who chooses Tesla will have to put in another USD 2 billion at the end of the year just to keep it alive. When we put it to a vote,

there was no one who would have chosen Tesla and everyone voting sided with GM.

The “wisdom” driving the operation of index funds, however, keeps pushing GM's share price down and Tesla's share price up. GM achieves large profits, pays a big dividend, and is massively buying back its own shares for prices at around six times its annual earnings. This is decreasing the number of shares in circulation, its market capitalisation is not growing, and the weight of GM shares in the index is dropping. On the other hand, Tesla needs more and more money every year just to cover its losses and must repeatedly issue new shares. Because the market is so far ignoring Tesla's inability to generate a single dollar in profit, not only does the share price keep increasing, but, due to the issues of new stock, its market capitalisation and weight in the index continue to grow at an even faster pace. Paradoxically, due to passive investing, at least on a relative basis, money flows away from shares of inexpensive and profitable companies and flows into shares of an expensive company constantly making losses. How many passive investors realise this?

Problem number one – dearness of the index

According to *The Wall Street Journal*, 41% of this year's growth in the S&P 500 index is due to the rising prices of just five stocks: Facebook, Amazon, Apple, Google, and Microsoft. This simply results from the way indices work. The most money flows into the stocks of the largest companies regardless of how expensive they are. And they are indeed expensive. In one debate forum, Jan Dvořák recently asked an interesting question: what would be the PE of a single company



combining Facebook, Amazon, Apple, Google, and Microsoft? I immediately set about to calculate this and came out with 30.6. That's pretty high, isn't it?

Some may object and insist these market leaders deserve this high valuation because they have a great future ahead of them. This may be true, but, to that point, I would like to recollect an article in *Fortune* from August 2000 headlined "Ten Stocks to Last the Decade". These were the market leaders at that time: Nokia, Nortel, Enron, Oracle, Broadcom, Viacom, Univision, Charles Schwab, Morgan Stanley, and Genentech. Back then, it seemed that the future belonged to them and the fact that their stocks were expensive according to all reasonable measures was also disregarded. Over the following 12 years, these stocks lost 74.3% of their market value.

There is no idea in investing which would be good or bad under all circumstances, but the price of the investment is always crucial. And this is the main problem with today's index investing. According to data from Standard and Poor's website, the PE of the S&P 500 index is currently 24.1. This is measured using actual reported earnings (and not from numbers variously massaged and restated by the companies and stockbrokers) as at the end of March 2017. The index's earnings were USD 100.29 and the index's value at the end of June was 2423.41. This results in a PE of 24.1. When the market is this expensive, we believe we can expect the index to provide returns of around 2% per annum over the next ten years. My ideas about attractive investments are rather different from that. Those investing today into the S&P 500 unwittingly are buying

into very low future returns. I think it is no coincidence that the US market is the most expensive among the big markets and that index investing has advanced the furthest there. There is certainly a relationship between these two facts. Other markets are substantially cheaper, and this is why we have only approximately one-third of our portfolio invested in the US market.

Crowding

The massive influx of money into index funds brings even additional risks. The two main risks are those of crowding and low liquidity. When the originally simple and good idea of passive investing is seized upon by the masses and pushed to its extreme, this results in crowding. For example, the Nasdaq index and certain sector indices are places where crowding is presently the most serious.

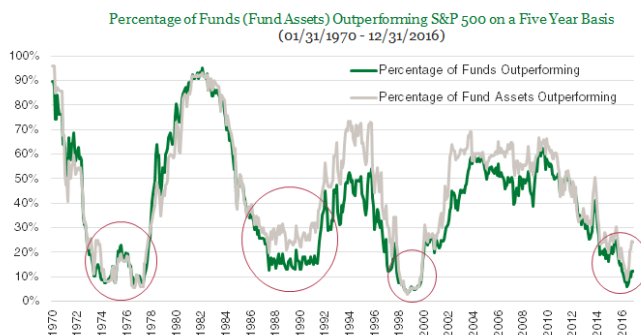
Every transaction needs two parties: a buyer and a seller. Here, the buyers are index funds into which money is currently flowing, whereas the sellers are actively managed funds out from which money is flowing. As we know, the nature of index funds is to buy especially the most expensive stocks. Actively managed funds are selling them willingly. At present, it still seems that index funds are nothing less than the Holy Grail itself. In fact, index funds are essentially the sole buyers. This is especially true regarding the most expensive companies losing the most money. When this trend reverses itself, to whom will the index funds sell these stocks? To the active funds? Not at those prices – but only when the share prices will be maybe 30% or 50% lower. Perhaps it will be altogether impossible to do so. In a situation where index



funds go from the position of sole buyer to that of sole seller and the crowds of investors start pushing to get out the doors, the index funds will encounter an immense problem of illiquidity and an impossibility to sell their stock. The same commentators who are now shouting “Index funds forever!” will start to bellow “Index funds never more!”

Cyclicality

Will such a turnaround come to pass? I think there is no doubt about it. After all, this will not be occurring for the first time. Take a look at the following graph. Relative performance of passive and active funds is cyclical and the trend often reverses itself at major market turning points as explained next.



Source: Nomura Instinet; Joseph Mezrich

So, the question is not whether but when. The longer this takes the more dramatic the reversal will be. Imagine an absurd situation wherein 100% of all money would be invested in passive funds. This means that no one on the market would be interested in the price of anything. The market would collapse and chaos ensue. It is clear that such an extreme situation will never occur. The market would

start collapsing much sooner than that. Even today's 23% market share of passive funds bears a high risk. In fact, there is a lot more passively invested money even than that, because a number of active funds in practice index their portfolios without advertising it to the public. I believe that we are far beyond the level of what the market could absorb in the case of a trend reversal.

Many things in the market are cyclical in nature. Since the early 1990s, when I started out in the markets, there have been several changes in investor behaviour trends regarding active and passive funds. Active investment was praised in the mid-1990s, around 2004, and immediately after the Great Financial Crisis. In contrast, passive investing was dominant in the early 1990s, at the end of the 1990s, just before the Great Financial Crisis, and today. Notice that people favour active investment after major market crashes whereas they cling to passive investment before them.

This is rather easily explained. Passive investing fares well when a market is rising over the long term. That is especially true towards the end of that rise, when more and more investors are jumping into indices, lured by the seeming ease of making money on the bull market. Active investing is preferred after market crashes. That means investors respond once again to past development even though they should be doing exactly the opposite and preferring active funds at the close of a bull market. The absolutely best sign of an approaching reversal is when active investing is pronounced dead, as is often heard today.



Oftentimes, however, investors do not see this cyclicity. Instead, they extrapolate the current trend and essentially buy what they should have bought much earlier. The present trend of shifting money into index funds must end sooner or later. This is unavoidable, because there is a finite amount of money in active funds. Paradoxically, it would be best for investors massively moving into index funds if the trend would reverse itself sooner rather than later. The sooner this happens, the lower their losses will be. When all index investors decide that it is time to leave index funds, I would not like to be in their shoes.

Is passive investing merely a myth?

Jeff Gundlach, a renowned investor, holds that passive investing is in fact only a myth. As we know, an index is not some independent and objective measure of market performance. Its composition changes based on the development of that market, which is to say depending on what it should itself be measuring. Moreover, it is influenced by decisions of a committee within the company compiling and managing the index.

In fact, passive investors are not even behaving passively. Judging by the name “passive investing”, one would think that a passive investor buys an investment and then does nothing with it for a long time. That is passive. In contrast, active investors are expected to intervene actively in the composition of their portfolios. Facts, however, indicate precisely the opposite behaviour of these two investor groups. Jack Bogle himself, the founder of The Vanguard Group and the leading proponent of passive investing, states that average turnover of

stocks in ETFs (exchange-traded funds) is 880% per year. This means that passive investors hold their investments for about 7 weeks on average. In comparison, the average stock holding time in the US is about 10 months (and at Vltava Fund it is much longer).

So, is passive investing really the norm or is it only a myth? We don't know. But do you know anyone who bought an index 20 years ago and who holds it to this day? Or better still, someone who started buying an index 20 years ago and was buying every month to this day no matter what happened on the markets? I don't. Index investing sounds reasonable in theory, but in practice I don't know anyone who would be able to apply it over the long term. It seems to me that index funds are instead a magnet to speculators who like the ease of trading them. The fact that index funds are much more frequently used by speculators than by long-term investors is also supported by the analysis from Credit Suisse. It states that the ten-year return rate of the S&P 500 (represented by the ETF with the ticker SPY) for the period beginning in 2016 was 6.9% p.a. and the dollar-weighted return for investors in this fund was only 3.5% p.a. Index funds are evidently used primarily as a means for short-term speculation.

Difference between small and large investors

Some well-known investors sometimes publicly recommend to individual investors to use predominantly index funds. One tends to forget, however, to whom they are actually speaking. They often have in mind the “average small investor”. In the Czech environment, we could consider this an



investor earning approximately double the average wage and his or her annual investments may range in the tens of thousands of crowns. For such an investor, it probably truly is better to strive towards building a passive portfolio. For larger, more sophisticated investors, however, I believe it is better to use active asset managers and diversify across several basic types of assets.

Even Buffett often speaks of the advantages of index investing for typical small and less-experienced investors, but I have not found a single case of Berkshire Hathaway ever investing into an index.

In fact, passive investing is much more difficult than it appears. To be successful, it requires that the investor have an iron will, resilience, patience, and an indomitable conviction as to its correctness. This combination of human characteristics is very rare. Co-operation with an active money manager can shift a part of one's worries from the investor to his or her manager. This may be a more feasible approach for many investors, and even for more sophisticated ones.

What does this mean for our investing?

The question you may be asking now is: Does the current preference of investors for passive funds present opportunities or dangers for us?

The answer is wholly unambiguous. For us, this trend is absolutely fantastic and we welcome it almost gleefully. In its study of active and passive investing, Credit Suisse states the following:

Excess return = skill × opportunities.

It is entirely clear that the boom in passive funds brings opportunities. What situation could be better than when an ever-increasing part of the market unthinkingly is buying whatever is represented in indices and with complete disinterest as to its price? The vast majority of passively invested money is “managed” by three companies: BlackRock, Vanguard, and State Street. The word “managed” is probably a misnomer, because there is not much management in the case of passive investing. I should rather say “administered”. These three companies are focused on hoarding assets rather than managing them. Essentially, it is difficult to say whether or not they would care at all about the results of those investments. After all, they are required to invest as dictated by the composition of the index, and it is that which determines their returns.

They are not much concerned with pricing, contemplating the values of the individual companies, or even risk management. The index is the index and that's that. We enjoy investing in such an environment and with such rivals. The more money there is in the passive funds, the less efficient the market will be in valuing the individual stocks and the more active we will be. Our greatest competitive advantage is patience and a long-term perspective. There is no question that passive investing deforms the market and creates new opportunities for active investors. Every day verifies this for us. At the same time, we realise that the present trend may still endure for some time and it may seem from the outside that our conviction as to the correctness of our investments is not reflected into the price of our portfolio. This can



happen, and it would be nothing out of the ordinary. In any case, this would constitute only a passing phenomenon. This brings to mind a story from 20 years ago.

A story 20 years old

In the 1990s, I was a co-owner of Atlantik FT and was working as a broker serving foreign investment funds investing on the Czech market. Among my clients was the company GMO. Almost exactly 20 years ago, I was sitting in their office in San Francisco, discussing the market with one of their portfolio managers. He was complaining to me that the US market seemed to them overly expensive and that they would rather hold back. At the same time, he was telling me that they were under great pressure from their clients, who were scolding them for not being aggressive enough. The clients wanted them to buy the stocks everyone else was buying and argued that the prices would keep on going up and so the funds should disregard such meaningless details as that the companies had no profits and were trading at valuations which essentially could not in any way be justified.

Many years later, I read in some text from Jeremy Grantham (the “G” in the company’s name) how this had all worked out in the end. GMO had stood its ground. For three years it appeared as though they were completely unskilled, because it was so easy to make money in stocks! Then came the year 2000 and a dramatic market crash. Due to its conservative approach, GMO fared very well and its portfolio’s performance strongly validated what it had done. Meanwhile, however, it had lost half of its clients. I don’t

know how things turned out for those clients, but my guess is that they probably lost most of their money.

I have great admiration for GMO. They faced up to great pressure and preferred being the target of criticism for poor returns than to be criticised for risking too much. We want to follow this example in our own investing. It would be very easy to make some quick money by aggressively buying the largest stocks in the main indices, closing our eyes to the fact that they are overpriced, and hoping that some even greater and greedier fool would later buy them from us. I think you know very well that we will do no such thing, and I believe that we clearly understand one another in that regard.

Comparison with an index

On the topic of indices, the question arises as to whether it makes sense to compare the performance of funds with an index. Of course it makes sense, but there also are a number of pitfalls in that. First of all, which index is appropriate for comparison? We are a global equities fund, and therefore we use the MSCI World Index. We are not a European fund, a US fund, or an emerging markets fund, and therefore such indices would be meaningless for comparison. A second question, then, is in what currency the performance should be compared. Our fund calculates returns in Czech crowns and hedges against currency risk. This means that it does not bear one large risk characteristic of global investing, and that is the risk of currency movements. Eliminating that risk has its price, of course, and these costs also should be reflected in any comparison with the index.



Another thing that needs to be accounted for is that the returns of our fund will differ markedly from those of the index over the short term. Whereas the index is rather broad, our fund is concentrated in approximately 20 stocks. Therefore, if in some short period the Fund's returns are approximately the same as those of the index, this is probably an exception. Most of the time the returns will markedly differ. In our worst year, we came in 45% below the index, whereas in our best year we exceeded it by 179%. I would think we will not exceed either of these percentages in future, but the returns in the individual periods will certainly differ.

Comparison is one thing, but trying to beat the index is quite another. If a fund manager strives to continuously beat the index at all costs this necessarily leads to sometimes investing too aggressively and taking on undue risk. Therefore, we undertake to do no such thing and are not intending to do so. There are periods when it is much better to hold back and give preference to controlling risk. As we have written in the past, in early 2009 we changed the Fund's strategy to the one we are applying to this day. In the context of this strategy, it can be expected that the Fund will lag the index in periods of a substantially bullish market while faring better in periods of market declines. This is what feels right to us.

Changes in the portfolio

We sold Deere and IBM.

Deere is a cyclical company. We bought it in a period when the market was overestimating the impacts of a cyclical downturn and now we sold it because it seems the market is

beginning to overvalue the impacts of cyclical recovery. Our return was 42%.

We started selling IBM just after the US presidential election and sold the last remaining shares in spring. Due to Trump's victory, there surprisingly occurred a possibility for tax reform the main component of which would be to decrease the corporate income tax rate. We started to reflect this possibility into valuations of US companies. IBM has an effective tax rate of around 15%, and therefore it will realise almost no benefit from such tax decrease as compared to companies having effective rates of 35%. Therefore, IBM suddenly became a much less attractive investment opportunity than it was before the election.

After a long time, we have no investment in the technology sector. Here is a small recapitulation of our investment forays into tech stocks since 2009: In that time, we bought and sold Oracle (2×), Seagate (2×), Microsoft, Hewlett Packard, and IBM.

Here is an overview of returns:

Oracle +16%

Seagate +56%

Seagate +32%

Microsoft +70%

Oracle +33%

Hewlett Packard + 123%

IBM -6%

We were rather careful with tech stocks. After all, this is a dynamically changing sector and



one can easily stumble. In the end, the returns are not bad, even though they could be attributed in part to the fact that we were in a bull market the entire time and only in part to our stock-picking. We will never know this precisely.

This is well illustrated by the example of Microsoft. When we were buying it at USD 22, there was a prevailing opinion on the market that this was a company nearing its demise. You may remember discussing it at the shareholders' meeting. We did not share this opinion, and therefore we bought the stock. It took a while, but then the market's opinion started to change. The stock went up by 100% and then another 100%, then put on a bit more still. An interesting thing is that overall profits today at Microsoft are lower than when we bought it, and earnings per share are approximately the same due to share

buybacks. The entire large price increase was due only to overpricing by the market.

We have bought the stock of a private equity company. Private equity can be a good business, but it depends on the people involved. We believe the company we bought into is at the top of its field, and it has been for more than 30 years. Its basic activity is to invest its capital into companies that are not publicly traded. One can easily become a party to this by buying its stock. Thus, we avoid two common disadvantages of private equity investments, which are frequently high fees and a necessity to remain invested for a number of years. In this case, we pay no fees and we can sell or buy more of the shares at any time. In addition, the company externally manages rather large private equity funds and the fees for their administration more than sufficiently cover all expenses for its operation. We really like this combination.

Daniel Gladiš, July 2017

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Before subscribing, prospective investors are urged to seek independent professional advice as regards both Maltese and any foreign legislation applicable to the acquisition, holding and repurchase of shares in the fund as well as payments to the shareholders.

The shares of the fund have not been and will not be registered under the United States Securities Act of 1933, as amended (the “1933 Act”) or under any state securities law. The fund is not a registered investment company under the United States Investment Company Act of 1940 (the “1940 Act”).

The shares in the fund shall not be offered to investors in the Czech Republic on the basis of a public offer (veřejná nabídka) as defined in Section 34 (1) of Act No. 256/2004 Coll., on Capital Market Undertakings.

The Fund is registered in the Czech National Bank’s list in the category Foreign AIFs authorised to offer only to qualified investors (without EuSF and EuVECA) managed by AIFM.

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Returns for the individual investments are not audited, are stated in approximate amounts, and may include dividends and options.

A BIT ABOUT TRUMP, A BIT ABOUT THE KORUNA

Dear shareholders,

In the first quarter of 2017, the Fund's NAV declined by 0.9 %.

No political event has divided people as sharply as the US presidential election in November, and therefore we return to it once again. President Trump has rather dramatically distinctive opinions on a number of issues. I must say that I like some and dislike others, and I am curious as to both how he is going to maintain them and how he will manage to put them into practice. It is still too early to draw any conclusions. I would not like to be as hasty as was the Nobel Prize committee, which honoured Obama practically before he even was inaugurated. Instead, I would like to consider what impacts Trump and his policies may have on developments in the investment environment and investing generally. Every investor must weigh this carefully and should be mindful not to let his or her political preferences influence expectations for the market developments. We ourselves try to maintain a rather agnostic approach, taking things as they are. I would divide considerations as to the possible impacts of Trump's presidency on markets into two parts. Regarding the first part, I will try to outline more generally what change in investors' thinking may occur, and regarding the second I will focus on certain specific steps being prepared by the Trump administration.

Waking the entrepreneurial spirit

Over the past eight years we have witnessed on both sides of the Atlantic a considerable shift to the left with numerous elements of socialism, a strengthening in the role of the state, unbelievable expansion of regulation of everything possible (and even some things unimaginable), establishment of subtle obstacles to the private sphere, and further alienation of the ruling elites from the common people. In such an environment, businesspeople naturally feel like outcasts living at the edges of society, guilty in their capitalist thoughts. In the Czech Republic, entrepreneurs are labelled parasites and many wake up at night in terror of what the state will think of next. The fact that our country is no exception is only small consolation.

Enter Donald Trump. In the first days after his inauguration, Trump held several meetings with top businesspeople in the US. As compared to Obama, who, as a proper leftist intellectual, was always a little disdainful of the private sector, this represented a complete U-turn. I am certainly no leftist, and definitely not an intellectual. By process of elimination, I suppose that makes me a right-wing savage. And from my right-wing savage worldview, I see the private sector as the driving force of progress and of the creation of wealth in society, whereas the state is a brake on both progress and wealth creation.

If Trump's relationship with American business is an indication that the private sector will cease to be seen as parasitic and instead as the state's driving engine and provider, and if the state limits its interference therein to a bare minimum, this could have a great impact on people's thinking. The entire entrepreneurial paradigm may shift and awaken people's slumbering entrepreneurial spirit. And that spirit, by the way, may be the most precious thing we have.

Investment implications

The above reasoning is not self-serving. The development as described may have dramatic impacts on the investment environment and on the valuation of various asset classes. Let me demonstrate this while taking bonds as an example.

We are living today in a time of historically low interest rates. The simplest explanation is to attribute this to consequences of the Great Financial Crisis nine years ago, but what if it were more complicated than that? Interest rates have actually been decreasing for more than 30 years. I believe this may be the result of a sense of insecurity among people. I would venture one step further and say that this insecurity is cultivated by governments. If the state manages to convince people that the future is very uncertain (as if it has ever been or could be otherwise) and

that a stronger, more powerful state is the salvation, then the ruling elite will have free rein to further strengthen its own power and restrict the liberties of the common people. In my opinion, that is exactly what has been happening in the developed world for at least the past 15 years.

A problem is that people who believe such fabricated paradigms and schemes behave accordingly also in their private lives, and that includes in how they invest. The phenomenon seen most frequently is a propensity for excessive caution. People prefer investments which they believe bear minimal risk, almost with no regard to their prices. In so doing, they in fact unknowingly undertake enormous risk.

Last summer after the UK referendum, when interest rates reached record-breaking low levels, there existed globally more than \$ 13 trillion worth of bonds yielding negative rates of interest. Why do investors buy these bonds for such absurd prices? It cannot be due to their returns, which are negative. Could it be for capital gains? Hardly. The cause may lie in the distorted ideas forced upon them by others. The worst thing is that such investments bear high risk. For me, the culmination of the absurdity currently prevalent on markets could be seen in last year's issuance of Austrian government bonds with 70-year maturity and a 1.5% annual coupon. It is very probable that such investment will bear a negative (possibly greatly negative) real yield for a period nearly equal in length to a human lifetime. Is that what a safe and conservative investment should look like?

Now, imagine that the paradigm shift described above comes about under such conditions. The state's rhetoric will change. People will no longer be brainwashed regarding future uncertainties and the necessity for a strong state. On the contrary, the state will support enterprise and people's entrepreneurship, their entrepreneurial spirit will awaken, and they will gladly and more willingly take responsibility for their own futures. Perhaps it is my wishful thinking, but such developments really could come to be. The Brussels elite's horror over Trump's victory shows that these people also understand this and feel themselves existentially threatened.

If common people develop a different understanding of the world, their approach to investment may also

change dramatically. Certain currently overpriced assets can be expected to go into an unforeseen and long-term price decline. One should be prepared for this and not be taken by surprise should this occur. I am thinking first and foremost here of bonds. Investors often debate whether equity markets are overpriced, but the dearth of stocks does not come close to rivalling the current expensiveness of bonds.

Regulation

Let us now look at certain steps that the new administration is preparing. The first, and probably least controversial, is a reduction in regulation. Everything is regulated these days. More and more regulations are introduced practically every day. There are so many regulatory directives and standards that it is impossible to keep up, and these often even contradict one another. Taken together, they constitute an immense barrier to business and to growing society's wealth. I recently read a Bloomberg article which stated that by 2020 global regulatory directives will be longer than 3 million pages and that the financial sector alone spends \$ 250 billion per year on regulatory expenses. I often ask myself, how far can this go? Someone has finally realised that the pendulum has swung too far and that regulation must be radically reduced.

We will never know what equity markets would have done had Trump not won the election. I, for one, believe, however, that their strong post-election rise is related to the expectation for cuts in regulation. Some pre-election proclamations by Hillary Clinton and her comrade-in-arms Senator Elizabeth Warren were so anti-business, bordering on the inquisitorial, that the market evidently breathed a sigh of relief that it had avoided the worst thanks to a Trump victory. A lower level of regulation should diminish overall costs of doing business and shift the aggregate supply curve to the right. This would mean higher GDP growth and lower inflation.

The financial sector will probably benefit most from the reduced regulation – and in particular banks, whether it be the largest of these or even smaller, regional ones. The pharmaceutical sector, on the other hand, is expecting stricter regulation. The pressure for lower drug prices in the US has been enormous in recent years and will likely grow even stronger.

Taxes

The US has one of the highest corporate income tax rates, but it should decrease from the current 35% to as low as 20%. This has two possible impacts, one local and one global.

The local impact consists, of course, in cutting the tax burden for US companies. The full tax reform will probably be more extensive and, in addition to a lower rate, will likely include also cancellation of the tax deductibility of interest payments and changes in the depreciation method. Although the precise form remains unknown, it is apparent that the impacts on individual companies will be substantial and, above all, various. The lower tax rate will have a different effect on companies with an effective tax rate currently at 37% than on companies with a 15% effective rate and yet another on companies that are not profitable at all. Likewise, cancelling the deductibility of interest costs (which I think is an excellent idea) will have different impacts on companies with large debts versus those with none.

It is a paradox that, even though the US equity market is quite expensive according to all metrics commonly in use (our net exposure to the US market is approximately 22%, so we have most of our money invested elsewhere), it is precisely the US market where highly attractive investment opportunities will appear. Tax reform is a game-changer and creates an ideal environment within which to select individual investments. In general, it can be said that investors should look for companies paying tax at or near the full rate, producing exclusively in the US, having no debt, and, ideally, which are pure exporters. As in the case of lower regulation, banks and insurance companies, which usually pay tax at full rates, should benefit handsomely from lower taxes. Such companies are also primarily oriented to the domestic market.

The global impact of tax reform occurs due to strengthened tax competition between countries. Back here in the EU, we can see a clear effort to unify corporate tax rates under the pretence of fairness and the like. The real reason, however, is to be able to raise taxes everywhere without any country thwarting such efforts. We must stand up to such malevolence, and tax competition between states is the best weapon for doing so. Until now, the US has been holding the short end of the stick, but, with a rate of around 20%,

it would be back in the game. Similarly, after leaving the EU the UK will probably have taxes even lower than it does today.

Repatriation of cash from abroad

US corporations have more than \$ 2 trillion dollars stashed abroad. This money lies largely inactive. Its transfer to the US is prevented by the inevitability of additional taxation at the full US rate. To avoid this, company bosses keep the money inactive on foreign accounts. This leads to such situations as Apple having record-breaking levels of cash – exceeding \$ 200 billion – but having to borrow in order to make dividend payments and buy back its own shares because almost everything is on foreign accounts. Thus, the cash-richest company in the world also has a debt of around \$ 80 billion. The most cash abroad is held by Apple, GE, Microsoft, Pfizer, IBM, Merck, and Johnson & Johnson.

Trump wants to facilitate the repatriation of cash held abroad under more advantageous conditions. Such step will have a markedly stimulatory effect. An immense sum of money will come into circulation and will start to be utilised more efficiently. Some will be used for investments, some for paying down debts, and some will be paid out to shareholders. In any case, that will be better than is the situation today. Furthermore, such repatriation will yield a one-off source of revenue to the national budget. President Bush did something similar, albeit on a smaller scale, and it had a positive impact on the dollar's exchange rate. I think we can expect the same thing this time.

Greater focus on fiscal policy

It is increasingly apparent that the aggressive monetary expansion in developed countries is running out of steam, and perhaps it even is causing harm outright. Therefore, it has become necessary to consider fiscally expansive steps. President Trump is thinking along the same lines. He wants substantially to increase spending especially on investments into infrastructure. This sounds nice, but it presents two problems. First, how is it to be paid for? I can think of no way other than by increasing the budget deficit. And second, what effect will greater fiscal expansion have? If it is initiated in the current advanced phase of the economic cycle and at a time of very low unemployment, the multiplication effect will be very small even as the upward pressure on inflation and interest rates will be very strong.

Scarcely any present-day investors have had to contend with an environment of high and rising inflation. The last time this occurred, most of today's investors were still in school, at best. To many, the risk of rising inflation may seem slight and distant. But let us not be lulled into a false sense of security.

Any potential higher rate of inflation will have very diverse impacts on individual companies. Companies combining a high value of economic goodwill with low need for capital investments will fare best. MasterCard may be taken as an example of such a company. Mining companies, to take another example, are at the other end of the spectrum.

If a higher inflation rate is also accompanied by a rise in interest rates, then companies with high levels of debt will be negatively impacted whereas banks should benefit from a probable widening of interest margins. So, too, should insurance companies, as their balance sheets are very sensitive to interest rates.

Although higher inflation generally swells companies' income statements and balance sheets, the higher interest rates will necessarily create pressure on share valuations due to the smaller multiples investors will be willing to pay for companies' profits. This should primarily affect growth stocks and shares of young companies or companies with no history or no profit. The valuations for such stocks typically hang on very long periods of substantial growth, and these projections are usually very sensitive to the discount rate.

US weapons manufacturers should be direct beneficiaries of Trump's fiscal policy.

International trade

Trump has drawn the most criticism for his ideas on free trade and international trade generally. This is no surprise. Every economics textbook convincingly argues in favour of free trade, and its limitation is always seen as detrimental for all parties involved. It is interesting to note, however, that truly free trade practically does not exist anywhere. If negotiations on a free trade deal between two parties take 10 years and the resulting contract has 1000 pages, then the result is not free trade. Free trade does not exist even within the EU.

It is clear that trade wars and actual limitations on trade would be bad. The global supply curve

would shift to the left, with all the usual effects that entails. For now, we'll just have to wait and see. In the end, I think it will not be so dramatic. There will be a difference between what Trump promised during the campaign, what he will actually try to implement, what he will manage to implement, and what form it all will finally take. In the end, this will be something like the third derivative of the original pronouncements.

Although this letter deals primarily with President Trump and the US market, we must not forget that there are also other, less expensive markets. Good opportunities may now be found also in Europe. Although this is a complicated continent, it is also the seat of many top companies which do not necessarily have a great deal in common with the European market.

The UK market is and will continue to be another source of good investment opportunities. Triggering Article 50 initiated the two-year period for negotiations on the shape of Brexit. It is a near certainty that there will be times during these two years when the negotiations will seem to be going badly. The market may respond overly aggressively to this, and it is just such times that may present buying opportunities. I personally believe that once the UK is outside the EU and things settle down a bit, Albion may be the most attractive country for business in Europe.

The Japanese market may be a very pleasant surprise, and its valuations are relatively attractive. Given Japan's current terrible macroeconomic situation, its debts and budget deficits, the most probable path for long-term development is a marked weakening of the yen. This could yield substantial, and in an extreme case even explosive, growth in Japanese stock prices. For foreign investors, however, it is necessary to hedge against currency risk.

In any case, there are very interesting times ahead. Things are moving and development is accelerating, which I enjoy seeing regardless of whether or not I like the individual steps and directions of such development. We are living in a dynamic investment environment full of historically unprecedented situations but also rich in investment opportunity.

Czech Koruna

Even as from a global perspective US domestic politics dominate investors' discussions, on Czech turf the main topics are the Czech National Bank's interventions to devalue the Czech koruna and, in particular, their pending discontinuation. We have always been rather averse to such interventions. We believe that efforts to maintain the CZK exchange rate at a non-market, devalued level regardless of the cost have an immense destabilising effect on the economy as a whole. They bring considerable costs to companies and individuals by distorting an otherwise relatively stable environment, doing so especially through distorted interest rates and an imbalanced exchange rate, which are the two most important parameters in any economy.

As investors, however, we can only accept the existing reality and strive to work within it. Whereas initiating such interventions is simple enough, terminating them is no easy task at all. This time point is literally close at hand and can come essentially at any time now. The main question, then, is what will happen to the koruna after the interventions are terminated. It will not be the first days and weeks which are important but rather the months and years ahead. In our opinion, the koruna will exhibit a one-off gain and then return to its modest rising trend vis-à-vis a basket of the world's main currencies over the long term. We base this opinion upon the following arguments:

First, if the CNB had to spend more than CZK 1.5 trillion to maintain the rate during the time it did so at CZK 27 per euro, then it is not likely that the rate will stay the same on its own after the interventions end.

Second, when we founded Vltava Fund in 2004, the CZK/EUR rate was around 32. From that time up to the start of the interventions in autumn 2013, the koruna had strengthened to 25.70. Since then, the CNB has maintained the rate artificially at 27. In theory, had the rate returned to its natural trend, it could have been somewhere between 23 and 24 today.

Third, in most cases the koruna is compared to the euro. That is logical because the EU is our largest trading partner. We must not forget, however, that in the last three and a half years the euro has not been doing very well. Its exchange rate against

the dollar dropped from 1.35 to 1.08, and the koruna's devaluation against other major currencies was in fact much greater than the euro rate would suggest.

Fourth, we are often presented the opinion that the koruna is overbought and that after the interventions are terminated there will be no one on the market to supply euros. This is more of a verbal intervention by CNB. In fact, the opposite may be true. At the 27 rate, the CNB is essentially the only investor willing to sell korunas in an unlimited amount. Once the central bank stops doing so, who will take its place in that role? At the 27 rate, probably no one. It is quite possible, however, that a substantial influx of investment in the Czech koruna will come from abroad, but only after the interventions end. On a global scale the Czech market is quite tiny, and worldwide cash flows are many times larger. We need only to sum up the purchases of the ECB, Bank of Japan, and Bank of England and add in the capital flight from China and it is clear that the volume of money seeking a safe haven is immense. If we add to this picture the negative rates in a number of countries and in a large proportion of bonds, then the combination of clear certainty regarding termination of the CNB's interventions, slightly positive interest rates, and expected long-term strengthening of the koruna can attract truly large sums of money.

What does this mean for our shareholders?

The Czech koruna is the Fund's base currency. Almost all of our assets are invested abroad and, as a rule, we fully hedge against the currency risk. For our shareholders from countries using the euro or Swiss franc, this means that their returns converted into their currency could also contain an additional return from the Czech koruna's strengthening. For our Czech shareholders, the strengthening of the koruna should have no negative effect because we hedge against currency risk. The ending of interventions will thus be welcomed by both groups, because currency hedging should become substantially less costly. This is currently very expensive due to market distortion. It presently costs us a lot of money and has had a negative effect on this year's returns. Frequent proclamations from the CNB about how interventions are generally beneficial do not correspond very well with reality. The sooner the interventions end, the better.

Changes in the portfolio

We sold three positions. Let's call them The Good, the Bad and the Ugly.

The Good is Hewlett Packard Enterprise. In 2012, Hewlett Packard was going through a rough period. The company wrote off a gigantic but not-too-old acquisition and its management had to resign. The share price responded by dropping sharply and the company became absurdly cheap. We had been pondering this for a long time but were eventually overcome by concerns about its future development and decided not to buy. Nevertheless, we began carefully monitoring its development and one year later our time came. Although the price was 60% higher than it had been a year earlier, the new management was taking very good steps, and the risk seemed acceptable. The shares were still very cheap and so we bought them. A little later the company announced its separation into two parts – HP Inc. and HP Enterprise – and we thus became shareholders of both. Even though it was clear to almost everyone that HPE was more valuable than HP Inc., for a while just after the division both stocks were traded at approximately the same price. There was only one thing to do: sell HP Inc. and move the money into HPE. This was one of the easiest trades of recent years and a beautiful example of market inefficiency. When we finally sold HPE, its shares were priced about 35% higher than those of HP Inc. This year, HPE will split off two parts of its business and subsequently merge them with two other companies. This may be a good step, but it complicates any estimate of the company's value. Given the higher share price, we therefore decided to sell HPE. Our return was approximately 123%, and we had a lot of fun.

The Bad is Teva. We bought Teva approximately five years ago. It seemed to be a solid company for a very low price. The share price stagnated for a while but then started to rise nicely and our investment thesis was gradually falling into place. The turning point came in 2015 when Teva announced the acquisition of a part of Allergan. This was the point at which we should have sold the shares at a nice gain. The acquisition was priced at approximately USD 40 billion, which at the time of its announcement was approximately 70% of Teva's market cap. We know from experience that most such large acquisitions prove to be value-destructive rather than creative. For

some reason, we did not factor this into Teva's case. Today, now that the acquisition is complete, it appears that it was extremely overpriced and has burdened Teva with immense debt. We sold the shares with zero profit. There are worse things in life, but it still represents lost time when we could have been making money elsewhere. For us, it is also a lesson for the future.

The Ugly is Bed, Bath and Beyond. When we bought this company it had practically all the parameters of a good investment: a simple and understandable business managed by its founders, a long history of positive results, the highest margins in its industry, very high returns on capital, zero debt, strong free cash flow regularly being returned to shareholders in the form of share buybacks, and a good share price. Its simple, well-functioning business model began to falter, however, not long after we bought shares. Although sales continued to develop relatively well, margins started to decrease significantly as did profits and free cash flow. Ultimately, we concluded that we apparently had fallen into a value trap wherein the share price was declining ahead of the company's diminishing value but all the time still appearing to be attractive. Whereas in the case of Teva it is possible clearly to describe the mistake we made and even pinpoint the time at which we made it, for BBBY the situation is more complicated. The truth is that once a company in this business gets into a difficult situation it is very difficult to turn it around. And that is why in the end we sold BBBY at a loss of around 30%. If I am not mistaken, it is only our second sale at a loss from a title we had bought in the past five years.

We have two new positions. The first is in Canada. It is a rapidly growing and very well managed company with a leading position on markets in Canada, the US, and Scandinavia. The second is in Denmark – a small country but one with many very interesting companies. We have had both companies in our sights for at least five years, and now the time has come.

Daniel Gladiš, April 2017

Note: The letter was written on April 4th. Two days later, the Czech central bank has ended the currency interventions.

This document expresses the opinion of the author as at the time it was written and is intended exclusively for promotional purposes. The investor should base his or her investment decision on consideration of comprehensive information about the Fund, which may be found in the Offering memorandum.

Only a qualified investor pursuant to § 272 of Act No. 240/2013 Coll. may become a shareholder of the Fund. Persons who are not qualified investors pursuant to the aforementioned provision of the Act shall not be allowed to invest.

The value of an investment may increase and decrease. Neither return of the amount originally invested nor increase in the value of such investment is guaranteed. The Fund's past performance is not a reliable indicator of future investment returns.

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.

The information contained in this letter to shareholders may include statements that, to the extent they are not recitations of historical fact, constitute forward-looking statements within the meaning of applicable securities legislation. Forward-looking statements may include financial and other projections, as well as statements regarding our future plans, objectives or financial performance, or the estimates underlying any of the foregoing. Any such forward-looking statements are based on assumptions and analyses made by the Fund based upon its experience and perception of historical trends, current conditions and expected future developments, as well as other factors we believe are appropriate in the given

circumstances. However, whether actual results and developments will conform to our expectations and predictions is subject to a number of risks, assumptions and uncertainties. In evaluating forward-looking statements, readers should specifically consider the various factors which could cause actual events or results to differ materially from those contained in such statements. Unless otherwise required by applicable securities laws, we do not intend, nor do we undertake any obligation, to update or revise any forward-looking statements to reflect subsequent information, events, results or circumstances or otherwise.

Before subscribing, prospective investors are urged to seek independent professional advice as regards both Maltese and any foreign legislation applicable to the acquisition, holding and repurchase of shares in the Fund as well as payments to the shareholders.

The shares of the Fund have not been and will not be registered under the United States Securities Act of 1933, as amended (the "1933 Act") or under any state securities law. The Fund is not a registered investment company under the United States Investment Company Act of 1940 (the "1940 Act").

The Fund is registered with the Czech National Bank as a foreign alternative investment fund for offer only to qualified investors (not including European social entrepreneurship funds and European venture capital funds) and managed by an alternative investment fund manager.

Investment returns for the individual investments are not audited, are stated in approximate amounts, and may include dividends and options.

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Dear Shareholders,

The Fund's NAV grew by 7.2% in 2016.

Our largest equity positions at the start of 2017 were Berkshire Hathaway, Total Produce, BMW, WH Smith, and Teva Pharmaceutical. The regional distribution of the Fund's net exposure is approximately as follows: 41% Europe, 34% US, 13% Asia, and 7% Canada. Our portfolio is concentrated into investments we consider to provide the best combination of returns and risk. Sufficiently attractive investment opportunities are rather rare, and therefore we endeavour to utilise these to their best advantage. Our 10 largest positions make up approximately 69% of our portfolio.

In the current market, the Fund's portfolio is priced at less than 11 times the earnings of the past 12 months. This means that for the past year the net profits of our companies amounted to approximately 9% of their market capitalisation (that is their earnings yield, which is the inverse of P/E). In our opinion, that is an attractive yield considering the quality and prospects of these companies. This number stands out particularly in comparison to interest rates that linger close to zero. By our estimates, the fundamental value of our shares stands about one quarter higher than their current prices. A fundamental valuation is not something static, however. Rather, it develops through time. In the case of our portfolio, it is quite solidly growing. At the end of this year, it should be on the order of one-third higher than today's prices. This ought to create sufficiently strong

pressure to push the prices of our stocks upwards.

Over the past eight years, which means from the Great Financial Crisis and at the same time from the change in our investment strategy, Vltava Fund's NAV has grown by 4.8 times. More precisely, it has risen by 387%. While it is true that the past eight years were very good for equity investments, our result is very good even by a global measure.

To achieve such returns, it is necessary also to have a little luck, and it is obvious that they are not sustainable over the long term. Be that as it may, we believe that we will remain among the better funds for a long time to come and that our returns will be good. Your expectations, though, should be realistic and should not be based upon returns from the past eight years.

In the next part of the Annual Report, as in the past, you will find quarterly letters to stockholders from the past year (taken together, these present a picture of our investments and opinions from last year) as well as more detailed data, including comprehensive historical results and audited financial statements.

We thank you for your support and goodwill through the years gone by and we look forward to our co-operation in the years to come.

Daniel Gladiš, February 2017



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The shares of the fund have not been and will not be registered under the United States Securities Act of 1933, as amended (the "1933 Act") or under any state securities law. The fund is not a registered investment company under the United States Investment Company Act of 1940 (the "1940 Act").

The shares in the fund shall not be offered to investors in the Czech Republic on the basis of a public offer (veřejná nabídka) as defined in Section 34 (1) of Act No. 256/2004 Coll., on Capital Market Undertakings.

The Fund is registered in the Czech National Bank's list in the category Foreign AIFs authorised to offer only to qualified investors (without EuSF and EuVECA) managed by AIFM.

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Dear Shareholders,

Vltava Fund's NAV decreased by 7.8% in 2015 and assets under management reached 1.9 billion Czech korunas as of 31 December 2015.

Our largest equity positions at the start of 2016 were Berkshire Hathaway, WH Smith, Teva Pharmaceutical, BMW, and Total Produce. Our portfolio is concentrated into investments which we consider to provide the best combination of returns and risk. Sufficiently attractive investment opportunities are rather rare, and therefore we endeavour to utilise these to their best advantage. Our 10 largest positions make up approximately 70% of our portfolio.

In the current market, the Fund's portfolio is priced at about 11 times the earnings of the past 12 months. This means that for the past year the net profits of our companies amounted to approximately 9% of their market capitalisation (i.e. their earnings yield, which is the inverse of P/E). In our opinion, that is an attractive yield considering the quality and prospects of these companies. This number stands out particularly in comparison to interest rates that linger close to zero. By our estimates, the fundamental value of our shares stands about one-fifth higher than their current prices. A fundamental valuation is not something static, however. Rather, it develops through time. In the case of our portfolio, it is quite solidly growing. At the end of this year, it should be on the order of one-third higher than today's prices. This ought to create sufficiently strong upward

pressure on the prices of our stocks to push them higher.

In the past seven years, which means from the Great Financial Crisis and at the same time from the change in our investment strategy, Vltava Fund's NAV has grown to 4.2 times where it had been. More precisely, it has risen by 324%. While it is true that the past seven years have been very good for equity investments, our results are nevertheless very good by worldwide standards. This result places our fund among the very top funds in the world.

To achieve such returns, it is necessary also to have a little luck, and it is obvious that they are not sustainable over the long term. Be that as it may, we believe that we will remain among the best funds for a long time to come and that our returns will be good. Your expectations, though, should be realistic and should not be based upon returns from the past seven years. Last year reminded us all that share prices can also go down.

In the next part of the Annual Report, you will find quarterly letters to stockholders from the past year. Taken together, these present a picture of our investments and opinions from last year.

We thank you for your support and goodwill through the years gone by and we look forward to our co-operation in the years to come.

Daniel Gladiš, February 2016



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Dear Shareholders,

Vltava Fund's NAV per share grew by 18.5% in 2014, and assets under management reached 1.9 billion Czech korunas as of 31 December 2014.

Our largest equity positions at the start of 2015 were Berkshire Hathaway, WHSmith, Catlin Group, Walmart and Teva Pharmaceutical. These are the same companies as from a year ago only in a slightly changed order. Our portfolio is concentrated into investments which we consider to provide the best combination of returns and risk. Sufficiently attractive investment opportunities are rather rare, and therefore we endeavour to utilise these to their best advantage. Our 10 largest positions make up approximately 70% of our portfolio.

In the current market, the Fund's portfolio is priced at about 12 times the earnings of the past 12 months. This means that for last year the net profits of our companies amounted to approximately 8% of their market capitalisation (i.e. their earnings yield, which is the inverse of P/E). In our opinion, that is an attractive yield considering the quality and prospects of these companies. This number stands out particularly in comparison to interest rates that linger close to zero. By our estimates, the fundamental value of our shares stands about one -tenth higher than their current prices. A fundamental valuation is not something static, however. Rather, it is developing through time. In the case of our portfolio, it is quite solidly growing. At the end of this year, it will be on the order of one-

-fifth higher than today's prices. This should create sufficiently strong upward pressure on the prices of our stocks to push them higher.

In the past six years, which means from the Great Financial Crisis and at the same time from the change in our investment strategy, Vltava Fund's NAV has grown to 4.6 times where it had been. More precisely, it has risen by 360%. While it is true that the past six years have been very good for equity investments, our results are nevertheless exceptional by worldwide standards. This result places our fund among the very top funds in the world.

To achieve such returns, it is necessary also to have a little luck, and it is obvious that they are not sustainable over the long term. Be that as it may, we believe that we will remain among the best funds for a long time to come and that our returns will be good. Your expectations, though, should be realistic and should not be based upon returns from the past six years.

In the next part of the Annual Report, you will find quarterly letters to stockholders from the past year. Taken together, these present a picture of our investments and opinions from last year.

We thank you for your support and goodwill through the years gone by and we look forward to our co -operation in the years to come.

Daniel Gladiš, February 2015



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Dear Shareholders,

Vltava Fund's NAV grew by 21.3% in 2013, and assets under management reached 1.5 billion CZK as of 31 December 2013.

Our largest equity positions at the start of 2014 were WH Smith, Berkshire Hathaway, Walmart, Teva Pharmaceutical and Catlin Group. Our portfolio is concentrated into investments which we consider to provide the best combination of returns and risk. Sufficiently attractive investment opportunities are quite rare, and therefore we endeavour to utilise these to their best advantage. Our 10 largest positions make up approximately 70% of our portfolio.

In the current market, the Fund's portfolio is priced at about 11 times the earnings of the past 12 months. This means that for last year the net profits of our companies amounted to 9% of their market capitalisation (i.e. that is their earnings yield, which is the inverse of P/E). In our opinion, that is a high yield and does not correspond to the quality and prospects of these companies. This number particularly stands out in comparison to interest rates that linger close to zero. By our estimates, the fundamental valuation of our shares stands about one-fifth higher than their current prices. A fundamental valuation is not something static, however, but rather it is gradually developing. In the case of our portfolio, it is quite solidly growing. At the end of this year, it will be on the order of one-third higher than today's prices. This should create sufficiently strong upward pressure on the prices of our stocks to push them higher.

In the past five years, which means from the global financial crisis and at the same time

from the change in our investment strategy, Vltava Fund's NAV has grown to nearly four times where it had been. More precisely, it has risen by 288%. While it is true that the past five years have been very good for equity investments, our results are nevertheless exceptional by worldwide standards. Our Fund has probably achieved the best results of all stock funds in the world during that period. (If you happen to find another fund which has had better results in the past five years than ours, please let me know so that we do not by chance brag of a supremacy which is not ours. To date, we have been unable to find such a fund.)

To quadruple your money and on top of that be the best in the world, it is necessary also to have a little luck. It is very unlikely that something like this will happen to us again. Be that as it may, we believe that we will be among the best funds for a long time to come and that our returns will be good. Your expectations, though, should be realistic and should not be based on returns from the past five years.

In the next part of the Annual Report, you will find quarterly letters to stockholders from the past year. Taken together, they present a picture of our investments and opinions from last year.

We thank you for your support and goodwill through the years gone by and we look



forward to our co-operation in the years to come.

Daniel Gladiš, February 2014

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Disclaimer :

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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Dear shareholders,

In 2012, the Fund's NAV grew by 1.3% and assets under management increased to CZK 1.1 billion.

Our largest equity positions in early 2013 were Sanofi, WH Smith, Wal-Mart, Berkshire Hathaway and Teva Pharmaceutical. Our portfolio is concentrated into investments that we consider the best in terms of their combination of yield and risk. Sufficiently attractive investment opportunities are relatively rare, and we therefore endeavour to take utmost advantage of them. Our ten largest positions constitute approximately 73% of our portfolio.

The market currently values our portfolio at approximately 9 times the earnings of the past 12 months. This means that for the last year the net profit of our companies was 11% of their market capitalisation. In our opinion, that is a lot and thus the share values do not correspond to the quality and prospects of these companies. This number especially stands out in comparison with interest rates that are at almost zero. By our estimate, the fundamental value of our shares today is about one-third higher than their current

prices indicate. The fundamental value is not static, however, but develops over time. In the case of our portfolio, it has been growing rather solidly. By the end of 2013, we estimate that the fundamental value will be in the region of 50% higher compared to current market prices. This should create sufficient upward pressure on the prices of our assets.

In the following part of the annual report, you will find the quarterly letters to shareholders from the past year. Taken together, they provide an overview of our investments and opinions for the year just ended.

We thank you for your support and patronage through the years, and we look forward to continued co-operation in the years ahead.

Daniel Gladiš, January 2013



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Dear shareholders,

Vltava Fund's NAV declined by 13.7% in 2011, marking our second negative result in the eight completed calendar years of the Fund's history. No one is happy with declines, but we must expect them sometimes. Any idea that all years will end on the upside would be unrealistic, and this is not even our goal. This would be theoretically possible, but an effort to attain a positive result each year would have a significant negative effect on total returns. Therefore, we prefer to pursue long-term objectives even at the cost of short-term decreases.

A fund's returns should be evaluated over the entire course of the market cycle, as it is easy to compose a portfolio that grows faster than the market during bull market periods but also that drops more sharply in bear market periods. Nor is it difficult to assemble a portfolio which drops less when the market goes down but that also grows more slowly in a rising market. Such portfolios say little about the skills of a portfolio manager. Rather, they indicate the amount of risk that is taken on.

Comparing a fund's returns with those of the market across the entire market cycle eliminates the influence of the portfolio's basic composition and reveals the actual result achieved by the fund's management. The current market cycle began at the turn of 2008 and 2009, when markets generally reached their low point and we at the same time adjusted the Fund's investment strategy to what it is today. The years 2009 and 2010 comprise the growth phase of the cycle, while 2011 represents the declining phase. We cannot yet say whether the entire cycle has reached its end. Only time will tell whether early October 2011, a time of great panic and low prices, will mark a return to growth and the start of another cycle.

The results of the Vltava Fund for this three-year market cycle are as follow:

Year	Return
2009	201.8%
2010	21.4%
2011	-13.7%

The total return was 216%. Through those three years, world equity markets rose by 22% as measured by the MSCI World Equity index.

The trade journal Hedge Funds Review regularly compiles a ranking of funds according to their returns for past periods. Of the 4,499 funds in the performance database, Vltava Fund ranked 21st overall and in 11th place among equity funds as measured by investment return for the years 2009–2011. Our return for that three-year period, as noted above, came to 216% overall, which is 46.8% p.a. The average return for all funds together was 7.34% p.a.

By such comparison, our results do not look bad at all; and they could have been even better had we not made two mistakes in 2011. A tennis player would call these unforced errors. We should have sold two titles earlier. The first is Chaoda. We had had growing concerns for some time about the fairness of that company's management, but we had been hesitant to sell the shares for the price at which they were trading at the time, and we were waiting for a better opportunity. This delay unnecessarily cost us money. The lesson we take from this is that once a company's managers appear not to be working primarily for the shareholders but rather to enrich themselves at the shareholders' expense, there is no advantage in waiting for a better opportunity to sell. The second error concerns the shares of the Finnish Talvivaara. During the course of the year, the company's fundamental value began to worsen due to shutdowns in mining operations. We saw it, but unfortunately our reaction came too late. We had not been able to get over a psychological barrier in our own heads quickly enough. Had it not been for these two errors, our total return for last year could have approached zero. Although we scarcely anticipate ever reaching a state where we will be making no mistakes, we do try to chronicle and describe them so that we make as few of them as possible in future.

The rest of the titles in the portfolio fared relatively well. The seemingly boring "blue chips" from developed markets did best. We drew attention to the anomaly in their valuations in our previous commentaries. This still holds true in many cases,

and during the greatest market slump at the turn of summer and autumn we increased our positions in those even more.

What can we expect this year?

Last year's market events were dominated by escalating problems of the euro zone, and, as not much has been resolved to date, that probably will be true again this year. The key to the solution is in the politicians' hands, and their behaviour is difficult to predict. It might be easier, therefore, to imagine the state towards which the euro zone is headed, as this is being driven by market forces that cannot be overcome. At the end of the decade, the euro zone could look like the following:

1. The core problem of the countries in the so-called olive belt (i.e. Greece, Italy, Spain and Portugal) relates to their payments balances. If this is to be solved, it is necessary for these countries' effective real exchange rates to drop significantly in comparison to the world around them. There are three ways to achieve that. The first is for inflation to be much higher in the surrounding countries than in those of the olive belt. So far, however, just the opposite is true. The second would be for wages and prices to decrease significantly in the countries of the olive belt. This is very difficult to achieve in practice. **Therefore, the third possibility is the most probable, which is for them to introduce their own currencies and then to devalue all of these.** The state debt will be partially written off and private debt will be reduced by its denomination. Greece will probably be the first in line.
2. In the rest of the euro zone, fiscal union will occur in larger measure, with there being a unified budget and government.
3. The European Central Bank will have the authority to print money and will be owned either by the central government or by the government of one of the euro zone countries. In choosing between a strict monetary policy and preserving the euro, they will choose the second.

4. The individual members of the euro zone will either go bankrupt or will have to subject themselves to central directives. They say capitalism without bankruptcy is like Christianity without hell. States must operate with the knowledge that the possibility of bankruptcy does exist, and investors must lend to them under conditions that reflect this risk.

This arrangement will be much more stable and much less costly in the long run than to preserve today's status quo. As to by what means and how quickly we will reach that place, this scarcely can be predicted. Perhaps today's leaders of the euro zone countries will need first to be replaced through democratic processes. The current leaders are tied too closely with constructing the EU and the common currency.

It is important for us as investors to recognise that this development will bring the downfall of many companies – but also many winners. In connection with market volatility, it will continue to bring many excellent investment opportunities. Even though Europe is not very competitive as a whole, a number of European companies are very much so. One example to demonstrate the case as a whole is that of Sanofi Aventis, a global pharmaceutical company based in France and comprising one of the largest positions in our portfolio. The French market dropped by 17% last year, and, due to their exposures to southern Europe, the French banks are among the most endangered. Despite all that, the share price for Sanofi Aventis increased by 18% (plus a 5% dividend). Most of the company's sales come from areas not only outside of France but entirely outside of Europe. The problems of the euro zone affect it only marginally. Indeed, a weakening euro is even a great advantage to the company. There are many cases of this sort, and our task is to find the best of these. It is worth noting here that we are not regionally limited in our investments. We have invested 31% of the portfolio in Europe but only 12% in the euro zone countries (and in the "better" part at that). If we would so choose, we could avoid Europe altogether, but, because there are a number of very much undervalued and high-quality stocks, there is no need to do so.

Selection of individual titles is the key to achieving good returns. While this may seem obvious, the opinion has recently become popular that individual stock-picking is rather pointless due to the historically high correlation between the individual markets and shares. This view is rather misguided, but it plays into our hand. High correlation between share prices does not mean that all stocks will have the same or even similar returns. Correlation is important for speculators, whose speculative (you cannot even say investment) horizons can be counted in hours or days. Correlation means nothing for long-term investors. The fact that fewer and fewer investors seek to find the best individual opportunities creates an ideal investment environment for us. We try to make the most of it.

Price vs. value

Price and value is a favourite topic of ours. Although the price of our portfolio (expressed by its NAV) is lower than a year ago, its value is recognisably higher. The basis of our investing consists in seeking out companies whose shares are selling for significantly lower prices than are their fundamental values and on the assumption that prices will in time approach the values. We have a view as to the value for every individual stock in the portfolio, and therefore we can picture the value of the portfolio as a whole. It is higher than a year ago. Most of the stocks in the portfolio have risen in value (due to their growing profits and dividends). Moreover, we swapped certain expensive shares for others with a more favourable ratio of price to value. The reinvestment of dividends received also played its part. Therefore, all our activities focus on increasing portfolio value. We can illustrate this by the following example.

Let us presume there is one share A and one share B in our portfolio. Each costs 100. The price of the portfolio is therefore 200. Let us further presume that the stocks each have a fundamental value of 150. Therefore the portfolio's value is 300.

Should the price of share A increase to 150 and the price of share B drop to 50, the price of the portfolio will remain unchanged at 200. As share A has reached the level of its value, it is pointless to keep it and so we

sell it for 150. For the cash obtained we buy 3 shares of B for 50 each. Our portfolio now consists of 4 shares of B with a total price of 200. The price of the portfolio has therefore not changed. What has changed, however, is the value of the portfolio: the 4 shares of B have a value of 600. Therefore, the portfolio's value has doubled. You cannot see this by looking at the surface, as it were, because its price does not yet reflect the underlying value.

This is of course a simplified example, as generally such things are not so black and white, but it demonstrates our way of thinking about creating value for the shareholders and it also shows the potential disparity between price and value.

One of the Benjamin Graham's greatest insights says: ***"In the short run, the market is a voting machine but in the long run it is a weighing machine."***

In the long term, therefore, the market will weigh the prices of stocks according to their fundamental values. That has always been the case, and it always will be.

What to do with money?

There are many possibilities for how to preserve and grow one's money: stocks (both domestic and foreign), bonds, bank deposits, real estate, commodities, art, gold... Currently, people favour bonds, deposits and gold while shares have become rather unpopular. This is a good thing for us, **because only unpopular assets can be acquired at truly inexpensive prices.**

In recent years, a situation has evolved wherein many companies are considered safer entities than are most governments. Thus, we now can compare on the one hand the world's best companies, which are professionally managed, profitable and financially strong, and on the other hand the dangerously over-indebted and inefficient states managed by politicians whose only goal is to win the next election.

The financial markets are not oblivious to this situation. It is no accident that at the end of 2011 it was cheaper to insure against the bankruptcy of companies such as Coca Cola and Nestlé than against the bankruptcy of countries such as Germany, Japan and Switzerland. Moreover, in a number of cases the stocks of such companies are priced at attractively low levels. When confronted with the debt crisis in Europe, the standard response of some investors was to sell everything. With time, however, they will come to realise that the shares of strong and high-quality corporations offer a favourable combination of low price and safety.

Taking into consideration both risks and expected returns, we think money is best invested into very high-quality, professionally managed companies which are profitable, financially strong and stable and whose strength and stability are often much greater than that of the countries wherein they reside. Companies that do not cause one to worry every day about how they are being operated. Companies available at prices which implicitly indicate double-digit annual returns in the years to come. The portfolio of Vltava Fund is composed of such companies.

Daniel Gladiš
February 2012

Dear Shareholders,

we had another good year in 2010. Vltava Fund's NAV rose by 21.5%. That is a very good result both in absolute terms and relative to the markets. The main equity markets moved as follows last year: World +7.8%, USA +12.7%, Europe +7.3%, Japan -1.2%, and China -14.3%. Our performance was therefore much better than that of the world equity markets. It was also a lot better than our long-term goal of averaging 10% p.a. NAV growth, and it was superior to our return expectation at the beginning of 2010. In thinking about return, we should not forget that we live in an environment of (still) low inflation. Inflation in the Czech Republic was roughly 2% last year, thus making our real return nearly 20%.

The year 2010 was a rather eventful one, and it was dominated by several macroeconomic themes. Europe has drawn to itself the main spotlight, which is focused squarely upon its fiscal and sovereign debt difficulties. With their similar problems, the US, UK, Japan and increasingly China are by no means escaping that glare either. The latter country continues to struggle with an undertaking – central planning in a state-owned economy – which has defeated all those who have attempted it.

Macroeconomic developments will likely play a major role in 2011 and also in the coming years. We perceive four main issues. First, a lot depends on actions taken by governments. It will be important what they do and whether they get it right. Unfortunately, the role of governments will be larger than in the previous two decades. Many governments got their countries into deep troubles by being too active and spending too much. Now their goal

is to become even more involved and to gather more power and influence in order to solve the problems that they themselves created.

Governments in the western world are moving more towards socialism in order to stay in power, and the bureaucrats in Brussels perhaps best exemplify that. Governments in the eastern world will need to introduce a little capitalism for the same reason – to stay in power. China is the best example. That makes the whole world a bit messy and uncertain. Our goal is to find companies least affected by governments actions.

Second, most governments have to start to reduce their spending and vastly improve their budget balances. The persistent and growing budget deficits of the last decade or two are not sustainable. And if something is not sustainable, then by definition it has to change. If things would not change in a reasonable manner, then sooner or later all tax revenues would be consumed by interest payments for the government debt.

Many countries will need not only to bring their budget deficits down, but they will have to work towards balanced budgets – and in some cases even towards surplus budgets – in order to lower their total indebtedness. These outcomes are both inevitable and long-term in nature. They will have major impacts on the corporate world and its profitability. If you view the economy as a closed system, then lower cash outflow on one side (the

government's side), must be balanced by lower cash inflows on the other side (the side of consumers and corporations). And because many consumers are also heavily indebted, the main burden will be carried by corporations. They will simply be less profitable. Our goal is to find those least affected. (With a little luck, a large share of the decrease in earnings will fall to banks.)

Third, while it is generally understood that budget deficits must be cut and debt ratios reduced, this is no easy matter. There are several ways for countries to extract themselves from a debt crisis. Ideally, the economy would simply grow its way out of its difficulties. The debts in many countries are now so large, however, that the growth solution is simply beyond reach. Then, too, salvation might ensue from extremely low interest rates for a very long time. But those kinds of miracles do not occur. We already live in an environment of extremely low rates, by the way, and it is not enough.

It might be possible, at least theoretically, to solve the debt problem if someone else repays the debt. Well, if Greece were the only country in troubles, that might be the solution, but, since Greece is just one of many, this will not do. What else remains? Severely cutting expenditure to bring budgets into balance, perhaps? A nice idea, but politicians being politicians means that this is highly unlikely. That leaves two final options: default and printing money. These are the most probable. Some countries will default, and most countries will be printing money. While defaults will penalise mostly those holding the defaulted debts, printing money will punish everyone. Printing money is a dirty word among central bankers and governments, so

they use the more gentlemanly euphemism "quantitative easing", or just "QE". QE has been in full bloom for more than 2 years. QE essentially means that debts will be repaid with money that is worth less than the money that was borrowed. It is also commonly known as inflation.

During the summer of 2010, the markets were not doing very well and fear of a double-dip recession was in the air. Then, at the end of August, the Federal Reserve, which is the US central bank, announced additional purchases of government bonds - a new round of QE. From that time until the end of the year, US stocks soared by 19%. Other prices also went up a lot: oil by 16%, copper by 32%, corn by 43%, and cotton by 57%. Inflation ante portas!

Our goal is to find those companies that will benefit from higher inflation. Those will be companies that are able to pass cost increases on to consumers, companies that have so-called pricing power, and companies that operate with large proportions of fixed rather than variable costs. We have several such companies in our portfolio already.

Fourth, the fate of the euro and euro zone is another important matter. We can envisage several possible outcomes: (i) some countries leaving the euro and reintroducing their own currencies, (ii) managed default by some countries, or (iii) steady march towards political and fiscal union at the expense of huge costs, large transfers, loss of sovereignty and slow economic growth. All of these outcomes remain open possibilities for now. Our goal is to watch developments closely and find companies that will be least affected.

You may be wondering by now whether we have changed our investment philosophy. We

have always said that we are bottom-up stock pickers and now we are talking mainly about macroeconomic issues. There is no need to worry; we have not changed. We remain bottom-up stock pickers. The quality of individual companies, their potential and especially their valuations are still the main criteria for us. But we do recognise that the economic environment has changed, and it would be foolish not to take that into account. As always, and despite all the economic mess, there will be some companies that will thrive and prosper. Our goal is to find the best of them.

The present economic environment actually presents a good background for our investments. Why? Simply put, because it is uncertain. Uncertainty brings volatility and volatility brings opportunities. Warren Buffett likes to say that you pay a high price for a cheery consensus. This is very true. Now, we certainly face nothing today like a cheery consensus. Rather, we live in a world whose distribution of outcomes is flatter and with fatter tails. We love that! When we look at the past year, our best investments were made in May and in August – both periods of market fear. If there is something we can predict with

high probability, it is that periods like that will reappear from time to time, bringing with them excellent investment opportunities. We will be prepared and ready to buy at just such times and make the most of other people's panic.

Looking at the world today and considering its outlook several years down the road, we think that holding cash is a terrible option since the value of most currencies will go down in absolute terms. Holding bonds, that is to say lending money to other people, can be rather dangerous and, if combined with the risk of potentially growing inflation, it should probably be avoided. Holding high-quality stocks acquired at reasonable prices seems the best choice to us. That is what we have in our fund now. While we have no way of predicting what will happen to their prices in the coming weeks or months, we think the probabilities are very high that in several years time their prices will be a lot higher than they are today, thus making you richer in this uncertain world.

Daniel Gladiš, February 2011

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Dear Shareholders,

during 2009, Vltava Fund's NAV grew by 201%. That is about 9 times greater than the rise in the world stock market. Although we realize that we still have a lot of catching up to do after an extremely disappointing 2008, we are very happy with this performance. This result puts us at the very top among global equity funds across the entire world for 2009. Let's enjoy this together now, as it is very unlikely that we ever will see such a strong rate of growth again.

How could we triple our money in one year? There is no general recipe for this, but three main factors contributed to it.

First (and foremost), the stocks that we held or bought in the beginning of 2009 were mostly absurdly cheap. It had been quite clear that, unless the world was quickly coming to its end, they must start rising rapidly. The only question had been when and how fast. Their subsequent rise surprised even us by its speed. We were not so much amazed by its magnitude, however, since all of our stocks remain undervalued today even after their share prices have substantially risen.

Secondly, the recession seems to have had a much smaller impact on our companies' profitability than the market had feared. And thirdly, we had good luck in the transactions we made during the last year. In fact, pretty much everything we touched worked out well – so far at least.

One more look back

Today, more than a year after the economic and market collapse, certain conclusions can

be drawn that are relevant for our investment strategy.

1. It hardly ever has been more clearly evident that the price of a stock and its value are two completely different things. If the price of Asian Citrus, one of our long-term holdings, drops from GBP 3 to GBP 0.77 and then rises to over GBP 5, all during one year, it hardly can be argued that it has always represented the true fundamental value of the business, which, judging from its earnings, was basically not affected at all by the recession. There were many striking examples of such mispricing in last year's markets.
2. Looking back at the development of companies' businesses and earnings, it also can be seen that, in most cases, the fundamental values of those businesses changed much less during the recession than did their stock prices.
3. Although the price of a stock can deviate very far from its fundamental value in the short run, it does tend to move towards the fundamental value in the long run. Fundamental values – however subjective and imprecise they may be – are what matter most.



We have been saying these things all along, and it was no surprise to us that they were reconfirmed during the last year.

As stated in the 2008 Annual Report, our investment strategy depends upon the following two conditions:

1. That we are able to identify stocks which in the long run perform, on average, better than the market.
2. That we are able to hold our investments for as long as we like.

Our history demonstrates that we are indeed able to identify good and outperforming stocks, and we have been able to do that consistently. While we are continuously working on our stock selection, we have no reason to change our basic approach, and that is to look for fundamentally undervalued stocks with a long-term view.

Our problem in 2008 had been that we were not able to hold onto all of our stocks. In order to keep the Fund's leverage in check, we had decided to liquidate part of our holdings in the last few months of 2008. We sold some of our holdings and bought back part of our short position at quite disadvantageous prices. The leverage and risk were kept under control, which was good and necessary, but part of the fundamental value of the portfolio was forever lost. If we had not had to do that, our NAV now might have been a lot higher than it is.

That whole story was described in greater detail in the 2008 Annual Report. To put it differently, it would not matter to us very much if stock prices were to drop significantly as long as their fundamental values were not impaired. They will come back up nicely later.

What matters to us a lot, however, is outright loss of capital and that is what occurred in 2008.

We will never allow it to happen again. That is why we made what looks like a small – but is in fact a very important – change in our strategy at the beginning of 2009. We significantly reduced the Fund's leverage. While during the first 4 years our gross leverage was about 3, it rose to 4 during the 2008 market collapse. At the end of 2009 it was about 2.3. What does all this mean? It means that our leverage now is lower by about 25% from what it used to be in “normal times” and is only a little above half that from the autumn of 2008. The overall risk of the portfolio as measured by its leverage is at its historical low. It will go down further in the future.

We will still use leverage in future but to a smaller degree. That will mean much lower risk, and that is good. But what will it mean for our returns? It is probable that our returns will be a bit smaller in good times but much better in bad times. And when it is all put together and summed up, it might bring better returns with lower risk. It is worth noting that our spectacular 201% return in 2009 was achieved with much lower leverage than ever before, which is a very good sign. It might also suggest that the relationship between leverage and return is not a straightforward one.

Investing means trying to find a balance between many different things. After our dreadful 2008 experience and also as we get older (not necessarily wiser) we tend to value capital preservation and stability more highly than before. This does not mean that we have or will become feeble, unimaginative or idle.



No, we will continue to work very hard, as always, in trying to find the best investments there are, but we may have shifted a bit in what we believe the best investments to be. I

think that all of you who were with us through the 2008 decline know very well what we mean and are probably pleased to hear this.

Daniel Gladiš, February 2010

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Dear Shareholders,

When I sat down to write the four previous Annual Reports for the years 2004–2007, I always had to think hard about what would be the main theme of each report. Things were going very well, and not much was really happening in the financial world. I did not encounter that problem when I started writing the 2008 Annual Report.

The year 2008 was full of unprecedented events and wild market movements. Many books will surely be written about the 2008 market crash, and I will not try to analyse it here too much. Instead, I will focus on the two most important practical questions that shareholders ask:

1. How is it possible that our fund, which for almost four years had a performance that put it among the top 10% of the global equity funds, could have had such a bad performance in the second half of 2008? 2. What can and will be done so that it does not happen again? Let us go straight to the first question. The Fund's performance can be split into three parts: market performance, fund leverage, and stock selection.

Market performance

We invest in equities in various parts of the world and, although we hold just a few stocks (30 at the end of 2008) that represent only a tiny proportion of the world equity markets, their price movements, and especially in the short run, are to a large degree influenced by the movement of the world markets. The year 2008 was one of the worst years ever for stock markets. The global market as measured by

the MSCI World Equity Index declined by about 40%. Some parts of the world performed even much worse. Europe, for example, was down by 44% and the Czech market by 52%. The second half of the year brought most of the decline and culminated in a brutal crash across all markets in October.

World market performance was a very strong headwind for all equity investors. It is clear that in this environment it is very difficult to make money in equities. This statement does not need much elaboration. Instead, we should ask ourselves whether it was possible to anticipate the crash and avoid the consequences. Many investors claim today that they did foresee the crash coming, but in reality very few anticipated it. Indeed, there are literally thousands of analysts, market strategists and investors making public predictions all the time and it is thus logical that some of them will be right regardless of what happens. No one knows up front, however, who will be right. Since market crashes are actually quite rare and happen maybe only once or twice in an analyst's professional career, almost no one is in fact able during his or her lifetime to establish a track record as a successful predictor of market crashes.

Let us define a market crash as a sudden (in less than 1 month) broad market decline of at least 30%. How likely is it for something like that to happen? Standard financial theory tries to estimate the probability of similar events using statistical models based on historical market data. The main approach is to look at past market volatility and then



estimate the likelihood for market movements of different sizes. For example, a 10% one-day drop in the US market happened on average once in every 4 years, or once in 1,000 trading days. If we consider the 30% crash to be a series of three daily drops of 10% each, then the probability of this happening is once in 4 million years. Could we predict systematically and successfully something that was statistically not supposed to happen in several million years? Based on this theoretical approach, certainly not.

Now you may suggest that we should have considered even the remote possibility of something like this happening and have acted preventively. Well, we had considered that. In fact, we think about possible events and outcomes all the time. Every day, and in 2008 also through many sleepless nights. Acting preventively is not without costs, however. If you expect a market crash every year and you are wrong nine times and correct once, is it better or worse to act all the time as if the crash is coming?

In spring of 2008, we actually assigned a significant probability of a 20% market decline before the end of 2008. We nevertheless decided that we did not need to take any major action since we believed that our portfolio was of good quality yet fundamentally cheap and that it would perform significantly better than the market. What surprised us most was not the market crash but the relative underperformance of our portfolio. More about this later.

Let us go back again for a while to the question of market crashes. We said earlier that it was not realistically possible to predict the October market crash. Nonetheless, we

are not happy with this conclusion and have done a lot of work on this since last October.

First of all, we have looked again at the history. History tells us that there were two crashes in the last 21 years that were statistically not supposed to happen in 4 million years. The one in October 2008 and the one in October 1987. In the second instance, the US market fell by 30.7% in 4 days. Then there were 10 market corrections of 12–23% in 1929–1933 lasting 1–8 days. These too, we can say, were extremely unlikely to happen. Thus, we found that there were several market events during the last 100 years that were statistically not supposed to happen in millions or in some cases hundreds of millions years. Was there something wrong with the theory?

In the world of Modern Portfolio Theory and the Efficient Market Hypothesis, market returns are distributed according to the Gaussian distribution.

The curve has a famous bell shape, and extreme events are defined by multiples of standard deviations from the mean. Two-thirds of all outcomes fall within one standard deviation from the mean and the farther the outcome is from the mean the less likely it is that it would happen. For example, the drop by 22.6% in the Dow Jones index on 19 October 1987 was more than 6 standard deviations from the mean and should happen only once in more than 500 million years.

October 2008 showed clearly what is wrong with the theory. The whole theory is based on the assumption that individual events are independent of one another. For example, if you start tossing a coin, it never matters what the previous outcomes were, as the



probability of the next outcome is always 50:50. It is independent from the previous outcomes. But this ironclad rule of probability does not at all apply to the stock market. In the stock market, the outcome of the next event (tomorrow) is not independent of the previous outcome (today). During one week in October 2008, world markets fell by 25–30%. It was a sequence of 5 consecutive daily drops of several percent each. When all the markets dropped on Monday, investors did not start Tuesday with new brains and no memory. They were full of panic and fear, and many investors were forced to sell because of margin calls. It was very clear that the outcome of Tuesday was not at all independent of what had happened on Monday. This continued for several more days until for some reason the negative feedback was broken.

We have always criticised the Efficient Market Theory, and it was again proven wrong. Although this gives us some satisfaction, it will not help us to predict the next market crash. What it might help us to do, however, is to buy protection against the next market crash. In the future, we will consider to purchase (when appropriate) insurance against a large market decline. Most likely, that would be in the form of put options that are far out of the money. Because most of the financial world is still using the Efficient Market Theory, such options used to be quite cheap at the times when they give the most protection.

Leverage

Our investment strategy can be summarised as follows. Vltava Fund is a global long/short equity fund. “Global” means that we do not have a regional focus or restrictions. We are

searching around the globe for the best investment opportunities. “Long/short” means that we use both long and short positions. On the long side, we have a selection of individual companies. On the short side, we have a broad market index (or indices). This allows us to be less dependent on market movements and more dependent on our own stock selection. Our long positions are usually larger than our short positions, meaning we are in a net long position. If we are able to find enough good and low-priced investment opportunities, we are fully invested and our long positions are approximately twice as large as our short positions. If we do not for some time see good investment opportunities, we are not ashamed to hold cash and our long position is somewhere between being equal to our short position (so-called “market neutral”) and being twice as big as our short position.

The sum of long and short positions divided by the capital gives the gross leverage, and the difference between the long and short positions divided by the capital gives the net leverage. When we are fully invested, our gross leverage is about 3 and our net leverage is about 1.

The success of our investment strategy depends on the following two conditions:

1. That we are able to identify stocks that in the long run perform on average better than the market.
2. The ability to hold our investments for as long as we like.

The first condition is self-explanatory and does not require further comment. If we do not have the ability to find stocks that over time perform better than the market, our strategy



would not make sense and would have to be changed. We believe we have that ability to pick long-term outperformers.

The second condition however is more problematic. When we buy a stock, we do so because we believe that it is significantly undervalued and has potential to go up a lot, often by more than 100% over the next 3–5 years. The price trajectory from here to there can be very unpredictable. It can go up next week or go down a lot first or do nothing for a relatively long time, but, so long as the fundamental value of the company continues to rise, these gyrations never bother us. We are patient long-term investors and can hold the stock for a long time and wait for its price to move up closer to its fundamental value. Provided that we were able to hold our stocks as long as we liked, we were happy.

Then came October 2008, and markets started falling very rapidly. Many stocks were punished by forced selling from scores of investors who had been investing borrowed money, and the stocks literally collapsed. For a while, this did not matter to us because it was clear to us that panic and fear were taking over the market while the fundamental values of most of our companies were influenced much less than the stock prices were suggesting. Since we never borrowed cash, we thought we would just sit it out and wait for the storm to pass.

But as the market decline continued, our gross leverage kept rising. By definition, when a fund's NAV falls, its gross leverage rises. It eventually went up so much that we were no longer ready to let it grow further, because with it the risk to the whole portfolio was increasing. We decided to bring it under

control in order to keep the risk in check. In practice, this meant that we sold part of the long side and bought back part of the short side. The gross leverage and risk were kept under control, but some portion of the value was lost. This is something that we never – ever – want to do again. For that reason, we will slowly reduce the Fund's gross leverage to a level such that even a market collapse similar to the one that occurred in October 2008 would not force us to sell anything.

It is quite possible that markets will have heightened volatility in the foreseeable future. In that environment and if we continued to maintain the gross leverage at 3, we would have to add a third condition for the success of our investment strategy – and that is that our stocks would need to outperform markets at all times. That would of course be too difficult, if not impossible.

We have already begun the leverage reduction and have a medium-term target for gross leverage of 2. This means that when fully invested the short side would be about 50% of capital and the long side about 150% of capital. That combination gives the gross leverage of 2. The reduction will be fairly slow in order to maximise the portfolio potential. With gross leverage of 2, the Fund's investment strategy will be more conservative but with still significant growth potential.

Being more conservative in this case does not necessarily mean lower future returns. When we have selected a stock into our portfolio, we not only considered whether it is a good investment but also if it can beat the market. We have always needed to beat our short side. This perhaps led us over time to more aggressive investments than would be



optimal. It forced us to work harder and come up with really good investments, but in the market crash it was exactly these investments that performed the worst. It was in these stocks that we saw the most forced liquidations from other funds. That was quite understandable, because we could hardly have been the only ones that saw great potential in these investments. They attracted the most speculative capital and were punished the most later. We continue to hold most of those titles, and they will probably drive our future returns. We will still be looking for similarly attractive investments in the future, but we perhaps will not be quite so aggressive in our stock picking.

Daniel Gladiš, February 2009

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Stock selection

The selection of individual stocks is in normal times the most decisive factor in concentrated portfolios like that of Vltava Fund. It was relatively less important in 2008. We have made some great investments and also some that we wish we had never made, but that is always the case and will likely remain so in the future.

It is one of the paradoxes of life that sometimes when you work the hardest, the results are the worst. That was our 2008. We have tried to learn as much as we could from the experience and will endeavour to make the journey to the point where we all make money again in Vltava Fund as short as reasonably possible.

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Dear Shareholders,

It is fair to say that 2007 was a good year. Although our Fund's NAV performance was not what it had been in previous years, it nevertheless exceeded our longterm goal of 10% average annual growth and was far better than the performance of world equity markets.

Table 1. Fund's performance since launch

	Vltava Fund	Our long-term goal	MSCI World Equity, Local Currency
2004 (4 months)	8.60%	3.24%	9.03%
2005	29.81%	10.00%	13.74%
2006	18.90%	10.00%	13.52%
2007	10.77%	10.00%	2.82%
Total	85.68%	37.41%	44.75%

Our results look even better when we express the world markets' performance in the Fund's base or reporting currency, which is the Czech koruna.

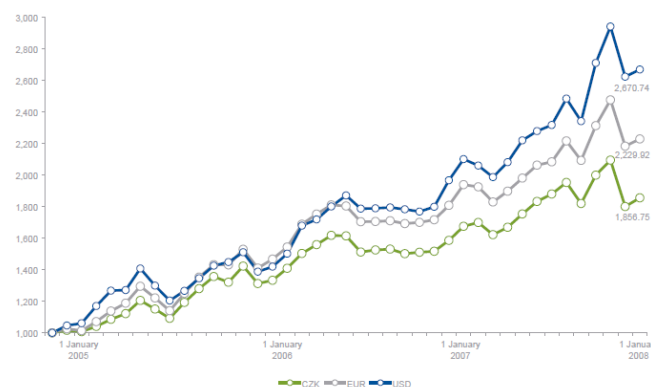
Table 2. Fund's performance vs. world markets in CZK

	Vltava Fund	Our long-term goal	MSCI World Equity, in CZK
2004 (4 months)	8.60%	3.24%	(3.81%)
2005	29.81%	10.00%	18.76%
2006	18.90%	10.00%	0.11%
2007	10.77%	10.00%	(6.62%)
Total	85.68%	37.41%	6.79%

In that we calculate the Fund's results and NAV in the Czech koruna, and since almost all of the Fund's investments are made abroad and are therefore denominated in foreign currencies, the exchange rates between the Czech koruna and those foreign currencies have an important impact on the Fund's NAV. Because the koruna has been very strong over the last several years, we have been hedging

most of our currency exposure back into the Czech currency in order to minimise the currency risk. That hedging, of course, comes at a price. We estimate that it cost us about 2.5–3% of NAV during 2007. That is significant, but the hedging paid off because the Czech koruna strengthened much more than that against most other currencies. Another way of looking at the importance of currency movements is to consider our NAV performance when expressed in dollars or euros. As visible from Graph 1, the koruna's strength means that a dollar-based or euro-based investor benefited from having the Fund's international investments rebased to the Czech currency.

Graph 1. NAV performance in CZK, USD and EUR



Although we are happy with the 2007 NAV performance, in fundamental terms the Fund actually did much better than its NAV suggests. How is that possible? Simply put, we think there are measures other than NAV that give a better picture of the Fund's performance. The main one is what is called "look-through earnings". It is the Fund's pro rata share of earnings from those companies that we hold in our portfolio. (For a more



thorough description and explanation of look-through earnings, please see our 2006 annual report). Look-through earnings per one share of the Fund were actually up by more than 60%! They moved from CZK 219 at the end of 2006 to CZK 355 at the end of 2007. How can this happen? Well, generally due to two things. First, the profits of the companies that we own continue to rise nicely. Secondly, we managed to buy some stocks very cheaply during the three market setbacks that occurred last year – in February, August and November.

The average price/earnings (P/E) multiple of the stocks that we had in the portfolio at the end of the 2007 was 7.5. And that is a historical P/E, based upon earnings that our companies made during 2007. We believe that the projected P/E – which is the multiple based upon expected earnings for 2008 – is about 6.5. These ratios are very low by any standard and suggest that we own low-priced stocks. In fact, these ratios have never been lower in the Fund's life. For comparison's sake, the Fund's historical P/E at the end of 2006 was 10.2.

Of course, one can say that low P/E might signal much poorer earnings prospects for the future, and that could certainly be true. But we try to select companies that are not only good and cheap, but also which have attractive earnings outlooks. So far, we neither see nor predict significant negative earnings developments among our stocks.

Let us do a bit more of simple mathematics. Lookthrough earnings per share of CZK 355 means that companies in our portfolio now earn in one year more than one-third of the initial price of the Fund's share. Investors that

bought the Fund's shares at CZK 1,000 in September 2004 see that their initial investments now provide a 35% return.

Dividends show a similar picture. The Fund's dividend yield is 4.2%. That means that the dividend per share is about 78 CZK. Therefore, investors who bought the Fund's shares at CZK 1,000 in September 2004 see that their initial investments now provide a 7.8% dividend return.

You may be asking by now, why then did the NAV last year grow by just 10.7%? Well, there could be two different answers. The first possibility is that there is a very good reason why our portfolio looks so cheap. That reason could be that the future global economic environment will be awful and so earnings will suffer greatly and develop negatively. Secondly, it could be that markets are not efficient and do not price stocks correctly at all times.

I am sure you have guessed that we do not believe the first reason to be the most important factor at play, but rather that the second is decisive. Acting accordingly, we pay little (if any) attention to the global macroeconomic outlook and the buzz of the news media. Rather, we try to focus on one thing above all else: to buy good companies at good prices. The markets may be quite unruly in this new year. There will be volatility, and stock prices may go down. But we believe that this would bring many opportunities to find good investments, and sooner or later it would show up positively in the Fund's NAV. If you read or hear about stocks going down, be happy. We are most likely investing your money at low share prices.



We like it when prices go down. Why? Because we receive several million in dividends every month from our investments. We use those dividends to buy more stocks, which bring us more dividends to buy more stocks to get more dividends....And the lower the stock prices the more stocks we can buy. Most people think that it is better if stocks go up, but for longterm value investors like us, it is better when stocks go down. If a dividend-paying stock were to go up and stay there forever, then we would make less money by accumulating that stock over time (and

collecting dividends) than if that stock were to go down and stay there forever. It is simple math, but people usually think otherwise.

While markets will continue to go up and down, we would like to thank you, the shareholders, for your steady support and loyalty. The fact that over more than 3 years we have seen practically no redemptions and that most of you have been adding to your investments and recommending us to new investors brings us our greatest satisfaction. We will work hard to continue to earn and deserve your trust.

Daniel Gladiš, February 2008

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Dear Shareholders,

As the earth has once more taken us all on another loop around the sun, it is again time for us to present you with our results for that period.

I am pleased to report that 2006 was a good year. We are calling it a Grand Slam year, in fact, as it is marked by four simultaneous achievements:

1. Our return was higher than our long-term goal of 10% average annual growth. 2. Our return was also higher than that of global equity markets measured by the MSCI World Equity Index. 3. NAV at the end of 2006 was at its all-time high, which means that all our investors had made money regardless of when they invested. 4. The Fund's assets have crossed the CZK 1 billion mark.

Table 1. Fund's performance since launch

	Vltava	Our long-term goal	MSCI World Equity
2004 (4 months)	8.60%	3.24%	9.03%
2005	29.81%	10.00%	13.74%
2006	18.90%	10.00%	13.52%
Total	67.62%	24.91%	40.77%

The performance figures shown above look good, but we have to keep two things in mind. First, the last 3 years were actually unusually good for stock markets and almost any fool could make money. As they say: "A rising tide lifts all yachts." That also helped us. The future will not always be this bright. There will be poorer years, or even loss years. Second, we are still only in the third year of operations and that is still too short a time to jump to conclusions about how good we are. We said last year in our annual report that the quality

of an asset manager only begins to show after at least 3–5 years. We are not there yet. Our results might still be reflecting more luck than skills. We have been repeating this like a mantra from the very beginning and it may by now sound like a broken record. But the truth is that we are dead serious. It cannot be repeated often enough. Moderate expectations are in order.

Although 2006 was less exceptional than 2005, it nevertheless ended up well ahead of what you should expect in the future on average. On the other hand, we are very happy with the quality of the Fund's portfolio and with the overall low cost market prices of its titles relative to what we see as their potential. That should bring satisfactory returns in the next few years. In fact, I would like now to say a few words about how we go about selecting stocks for our portfolio as well as how we measure their inexpensiveness and potential.

Every time we buy a stock, we see it not as some raw material for trading and speculation but as an ownership certificate for a piece of a business. This might sound familiar to many of you, since many of you have been, or are still, business owners. Buying stocks is essentially the same, and I would argue that it has many advantages. Let us compare starting a private business with stock investing.

To start a business or a company, you first have to come up with an idea and then be ready and able

to execute it. You have to get capital, fight with bureaucracy, deal with employees, clients, risks, and, at the same time, you are personally very closely tied to that business. You cannot sell it quickly and easily and in most cases you cannot leave it. The good part of this is the pleasure one derives from independence, challenge and achievement, as well as, of course, its economic benefits.

If you buy a company's stock, then someone else has already come up with the business idea, started the business and is managing it for you. Although you do not run it and have basically nothing to say about how it is run, the economic benefits are very similar to those from having your own private business. But the greatest advantage comes from your freedom. Moreover, the market continuously presents you with a very wide choice of such opportunities. There are many businesses of which you can buy a piece in the blink of an eye, and many of these are at prices so low as to be unimaginable if you wanted to buy the whole firm. If you do not like what you own, you can sell it just as easily. You have a bigger choice, you are not tied closely to any of your holdings, and you can have more than one or two of them in order to attain good diversification. I admit that buying stocks may seem too passive a form of business to some of you and I know that you like the challenge and adrenalin of actually running an enterprise, but I also think that the advantages are really worthwhile. In any case, if you like you can always do both.

When we buy a stock, we always think about it as buying a piece of a private business. We

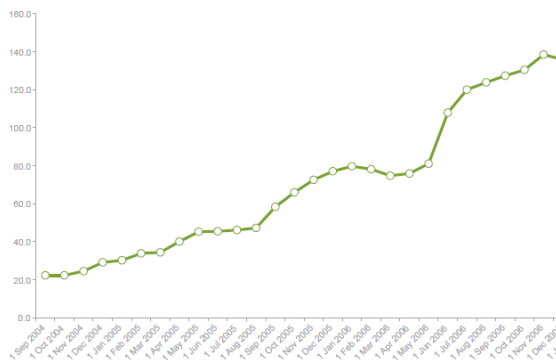
are constantly looking for what we regard as good companies, and then we wait for their share prices to look attractive so that we can buy them. Luckily for us, markets are quite irrational and are often driven by two essential emotions – greed and fear. We prefer to buy in the general atmosphere of pessimism, when fear prevails, since at that time reasonably good businesses are offered at unreasonably low prices. In fact, low prices make us happier than high prices. As lifetime buyers of stocks, low prices are good for us. The lower, the better. Fear and depression bring the best deals. On the other hand, from time to time, markets go too high riding on a wave of optimism and greed rules. This sometimes brings unrealistically high prices for the stocks we own. If that happens, we sell.

We normally have no idea whether the market is going to go up, down or sideways in the near future and, frankly, we do not much care. What we think we do know is how to recognize when a stock is substantially undervalued in the market. And that is what we concentrate on. We believe that if we buy at good prices a group of good companies whose earnings will be significantly higher in 3, 5 or 10 years, then that will over the long run be reflected in their stock prices. Well, this sounds easier than it is. So, have we been successful in this? Let us look at the figures.

We use various measures and statistics internally, but perhaps the best one to consider here is that of so-called “look-through earnings”, because it is simple concept that shows well the development

over time. What are “look-through earnings”? This is a concept of looking through the stock ownership in a given company and down to the bottom line, then figuring out what is your share of that company’s net profit. Here is an example. Suppose that we own 1% in a certain company and that the company has made annual profit of 100 million. Then 1% of that is 1 million in profits, or 1 million, is our look-through earnings. If the company makes 120 million of net profit next year and we still hold 1%, then our lookthrough earnings will be 1.2 million. We can do that for each company in the Fund’s portfolio and come up with the Fund’s total look-through earnings. **Graph 1** shows how our look-through earnings have developed since the Fund’s launch.

Graph 1: Net look-through earnings (CZK, million)

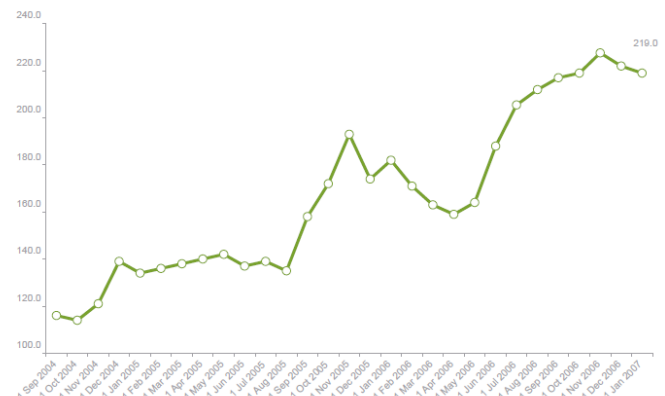


How do we calculate net look-through earnings? We take average earnings for the last 36 months for each of the companies that we hold and figure out what are our portions of those earnings. Then we do the same for our short positions and subtract the second total from the first. The result is net look-through earnings. Why do we use the last 36

months? It is because when we value a company and are looking at its earnings power, we always look at the average of the last 3 years. We do not take 1-year figures very seriously. They tend to be misleading.

We do not stop at net look-through earnings, since they are influenced by the size of the Fund. Therefore, we compute net look-through earnings per share. **See graph 2.**

Graph 2: Net look-through earnings per share (CZK)



We get this figure by dividing net look-through earnings by the number of shares issued by the Fund. That figure shows whether the earnings of companies that we have in the Fund are actually rising. As you can see, net look-through earnings per share have grown from 116 to 219. That is, by 88%. That figure roughly corresponds with the rise in NAV of 67.6%. We think this supports what we said above about picking good companies that grow their earnings. Indeed, if we put in the same graph the Fund’s NAV evolution and its net look-through earnings per share, you will

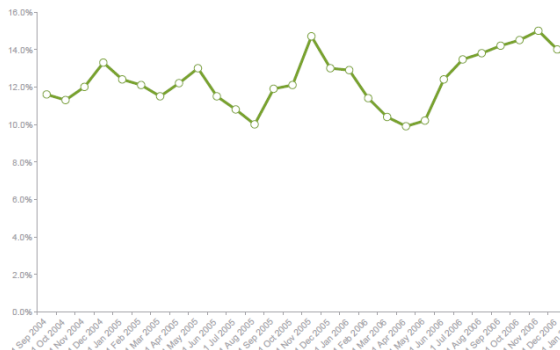
see how close they are to each other. See **Graph 3.**

Graph 3: Net look-through earnings per share vs. NAV (Same base)



Let me show you one more graph. If we divide net look-through earnings per share by NAV, we get net yield per share. This shows how high in percentage terms are look-through earnings relative to current NAV. See **Graph 4.**

Graph 4: Net yield per share



As you can see, the net yield fluctuates roughly between 10% and 15%. The net yield per share was close to 10% at times when markets were bullish, optimistic and expensive. Examples would be March 2006 or September 2005. On the other hand, the yield was close to 15% after markets had dropped. Examples would be November 2005 or summer and autumn 2006. These were times when we were generally buying. So, in the future, when you see markets dropping, you can be sure that we are buying inexpensive stocks that will make you good money over time. (We are quite optimistic in the sense that we expect markets to go down a lot from time to time and bring great investment opportunities.) Their earnings will sooner or later reflect themselves in higher prices and higher value for you. It will not be regular or evenly spread over time, but it will happen.

While markets go up and down, we would like to thank you, the shareholders, for your steady support and loyalty. The fact that over more than 2 years we have seen practically no redemptions and that most of you have been adding to your investments brings us our greatest satisfaction. We will work hard to continue to earn and deserve your trust.

Daniel Gladiš, February 2007

For more information

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Dear Shareholders,

another interesting year has passed, and we are pleased to present you with the results of the Vltava Fund SICAV, Plc ("the Fund").

The Fund came into 2005 with net assets of CZK 244.2 million and with the price (NAV) per share of CZK 1,085.99. At year's end, net assets were CZK 645.6 million (164% higher) and the price per share was CZK 1,409.77, which reflects NAV growth of 29.8%.

Almost 30% growth in the price per share for one year is a very good result indeed. In fact, it is a lot better than we had anticipated. We would be foolish if we expected to make 30% per year, that's for sure. And it would be equally imprudent if you, our shareholders, would expect us to make 30% per year in future.

Our long-term goal remains unchanged. We aim to achieve, on average, a 10% annual return. A goal is one thing, of course, but reality can be something quite different. The fact that we have so far outperformed our goal by a wide margin is no assurance that we will achieve our goal in future. What we can guarantee is a firm commitment to our investment strategy and a careful and conservative approach to investing.

Besides, the end of 2005 marked just 16 months since the Fund's launch. That is a very short time in investment terms, and after just over five quarters we still cannot say whether our results are so good because we are so smart or because we are lucky. To differentiate between skill and luck takes several years, at least. We believe that the

quality of an investment manager really just begins to show only after 3-5 years. So please look upon our initial results conservatively, as we do.

As in our first annual report, we would like to spell out here the main principles governing our investments. These were formulated in 2004, before the Fund was launched:

1. We do not believe in an efficient market.

The most common and still dominant approach to investing is based on an assumption that the market is efficient, that stocks are appropriately priced and that it is not possible therefore systematically to beat the market.

We do not share this view. On the contrary, we believe that the market is rather inefficient and that it is possible to find undervalued or overvalued stocks at any time. We aim to exploit these inefficiencies in our investment approach.

2. We do not use indexing or benchmarks.

In accordance with our belief in market inefficiencies, we do not follow any index and do not use benchmarks. Our view is that to rely upon a benchmark for guidance significantly predetermines investment results and ties the hands of the investor. To use a benchmark would be to contradict our goal of exploiting market inefficiencies. It would not be our intent to buy or sell a stock, for example, just because it is in or is dropped from a benchmark. We also believe that it should not be our goal to try and match the

return of a benchmark; rather it should be to help cover the future liabilities of our investors. We think in terms of absolute, not relative, returns.

3. We do not measure risk by volatility.

We believe that the concept of using volatility as a measure of risk is inappropriate. We do not think that the risk of not having a stock that goes up is the same as the risk of having too much of a stock that goes down. We define risk as the probability of losing the invested amount. Therefore, we apply a bottom-up approach in stock selection and try to buy stocks at prices well below their intrinsic values. The bigger the difference between a stock's price and its intrinsic value, the better. This is our way of managing investment risk.

4. We do not diversify beyond sensible limits.

We would not buy stocks that we do not like just to decrease the portfolio weight of stocks we do like. We consider too much diversification a bad thing that has a negative effect on returns. We believe that an investor can only achieve excellent results with a relatively concentrated portfolio. This approach forces us to think long and hard before making an investment.

5. We do not want to be the victims of market movements.

We do not believe that we can time the market, and, at the same time, we consider the markets today to have a mixed rather than generally attractive outlook. Therefore, we use both long and short positions. We are long on individual stocks and short for the market as a whole. This reduces our dependence on

the market's behaviour and increases reliance on our ability to realise alpha by selecting stocks that will perform better than average.

6. We do not play currencies.

We cannot successfully play currencies, and we do not play them. It is not our intention to expose the fund to currency fluctuations. We automatically hedge most of the currency risk back into the Fund's base currency, the Czech Koruna.

7. We put all of our efforts into the selection of good stocks at the right prices.

We realise that our investment results are most dependent upon our ability to select good stocks at good prices. Therefore, we apply a very well defined and strict method for stock selection. We recognise the importance of investment discipline and the danger of style drift. We have designed our selection method with these facts in mind.

8. We have no short-term goals.

We do not set for ourselves short-term investment goals. We regard short-term goals as often in conflict with long-term goals and thus as decreasing investment returns. Our focus on absolute returns while ignoring benchmarks and volatility allows us to think exclusively about the long-term horizon. Everything we do is directed toward long-term goals. We are quite happy to wait patiently until some of the stocks we own "wake up".

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Dear Shareholders,

You are holding in your hands the first annual report of the VLTAVA Fund SICAV Plc ("the Fund"). It is our pleasure to present you with the results of the Fund's first calendar year of operations.

We launched the Fund on 1 September 2004 with the initial price of 1,000 Czech Koruna (CZK) per share. At the end of 2004, after four months of operations, the price per share was CZK 1,085.99, which reflects the NAV growth of 8.6%. This is a very good start and a very good result and we are certainly very pleased with it. Please keep in mind, however, that four months is a very short time in investment terms. After just four months we cannot say whether our results are so good because we are so smart or because we are lucky. To differentiate between skill and luck takes several years, at least. We believe that the quality of an investment manager really begins to show only after 3-5 years. So please look upon our initial results conservatively, as we do.

Our long-term goal remains unchanged. We aim to achieve, on average, a 10% annual return. A goal is one thing, of course, but reality can be something quite different. The fact that we have so far outperformed our goal by a wide margin is no assurance that we will achieve our goal in future. What we can guarantee is a firm commitment to our investment strategy and a careful and conservative approach to investing.

We began in September with assets of CZK 192.2 million, and, due to the NAV growth and

new subscriptions, we finished 2004 with net assets of CZK 227.7 million.

Since this is our first annual report, we would like to spell out here the main principles governing our investments:

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BMW

Daniel Gladiš

European Investing Summit, 5 October 2017

Summary

BMW is readily understandable business with a moat, managed in the interest of shareholders and very attractively priced.

BMW – two complementary businesses: Automotive + Financial Services

		2006	2016	2016/2006
Cars sold	mil	1.37	2.36	72%
Motorcycles sold	mil	0.100	0.145	45%
Revenues	EUR bln	49.00	94.10	92%
Contract portfolio	mil	2.27	5.10	125%
Net profit	EUR bln	2.87	6.90	140%
EPS	EUR	4.38	10.45	139%
Dividend	EUR	0.70	3.50	400%
BVPS	EUR	29.24	72.08	147%
Price of common	EUR	43.51	88.75	104%
Price of preferred	EUR	43.52	72.70	67%

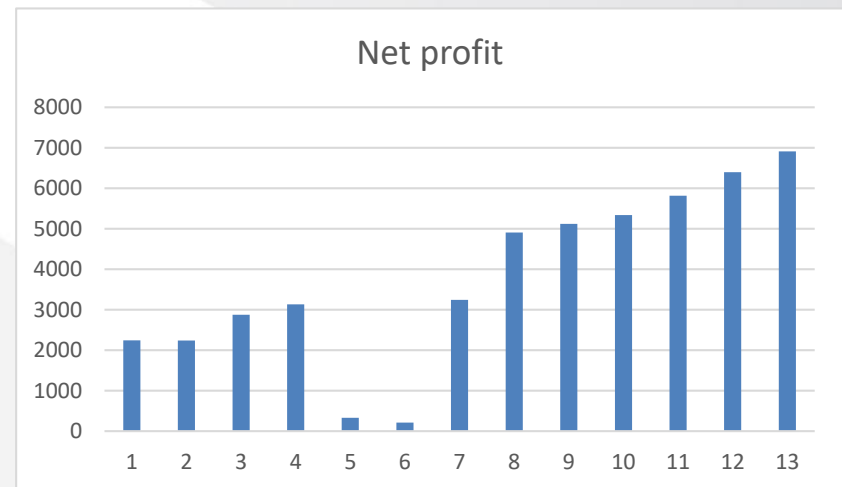
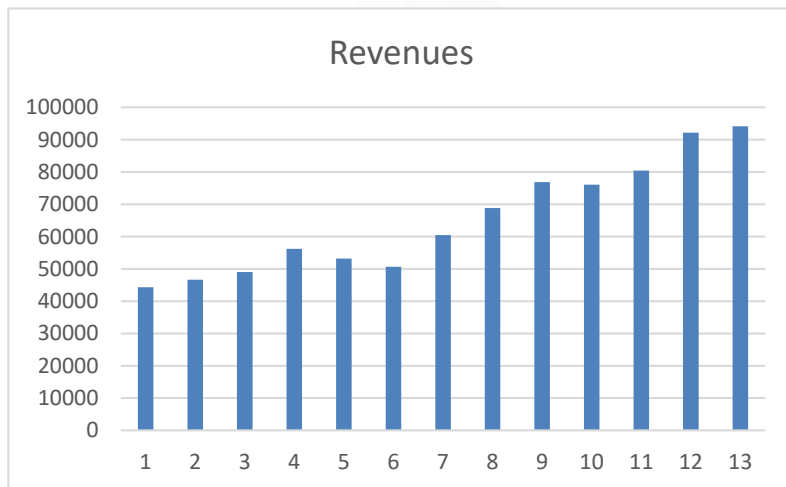
Does the company have a moat ?

- Returns on capital
- Brand value

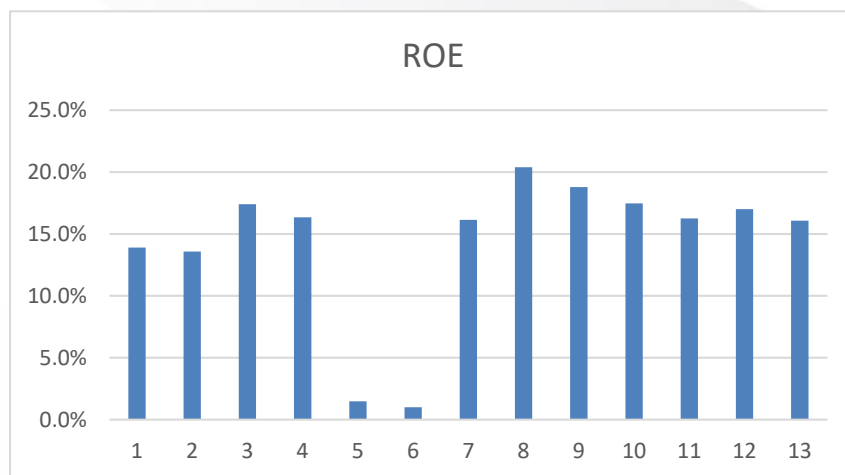
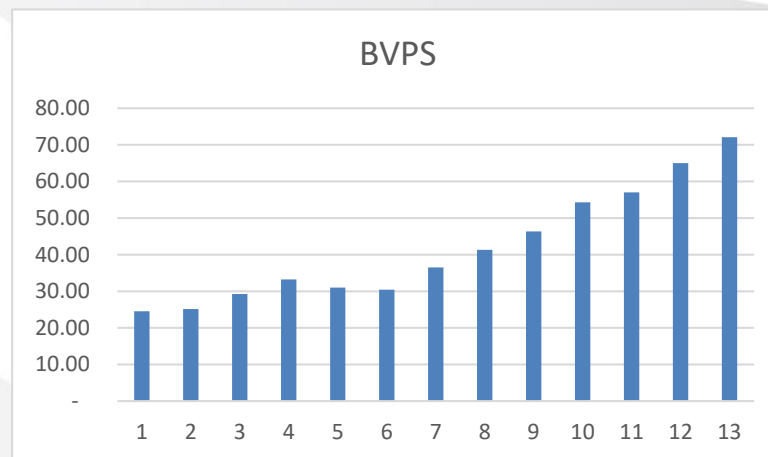
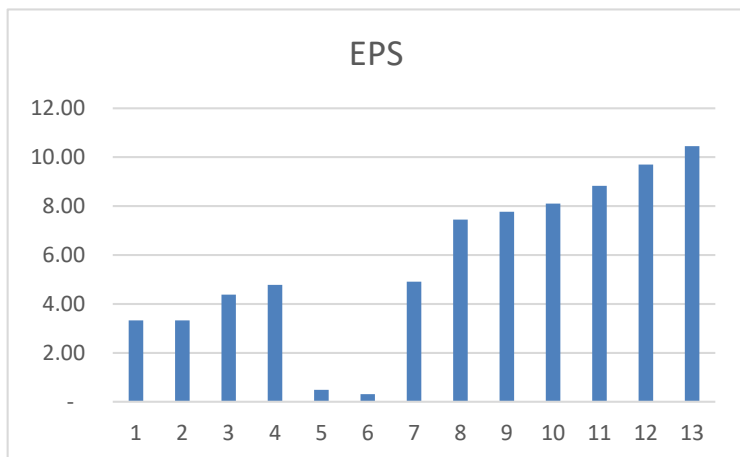
Is the company managed in the interest of all shareholders ?

- Stable majority owner for the last 100 years
- No overpriced acquisitions
- No large write-downs of assets
- No excessive management compensation
- Good capital allocation

Methodically and carefully marching forward (it is a German company)



Methodically and carefully marching forward (it is a German company)



Is the stock underprised in the market ?

Sum-of-the-parts valuation

- **BMW bank:** EUR 18 bln (1.6 x BV at ROE 18 %), EUR 27.3 / share
- **Automotive excess cash:** EUR 12 bln, EUR 18.2 / share
- That gives together EUR 45.5 / share.
- Implies EUR 28.5 / share for vehicles production.
- That is 3.3 x earnings and only about 48 % of its book value.

Sum-of-the-parts valuation

- **Brand value** = EUR 30 bln
- **Brand + Book value** = EUR 67 bln
- **Automotive at 8x earnings** = EUR 44 bln
- Let's settle at EUR 55 bln.
- **Bank + Cash + Automotive** = $18 + 12 + 55 = 85$, i.e. **EUR 129 / share**

ROE model

- 2017 EPS 11.9 EUR (average ROE 13 %)
- 2020 EPS 12.9 EUR
- Excess cash EUR 20 bln, 30.4 / share
- Cumulative dividends EUR 13.4 / share
- **2020 value:** EUR 116 (PE 9) + 30.4 + 13.4 = **EUR 159.8 / share**

Risks

- Peak auto
- BMW Bank
- Electrification
- Autonomous driving
- Interconnectivity

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The value of an investment may increase and decrease. Neither return of the amount originally invested nor increase in the value of such investment is guaranteed. The Fund's past performance is not a reliable indicator of future investment returns.

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ITV

Daniel Gladiš

European Investing Summit 2016



VLTAVA FUND

My previous presentations

- 2012: WH Smith + 154%
- 2013: Total Produce + 119%
- 2014: Catlin Group + 43% (taken over 3 months later)
- 2015: Sberbank + 105%
- 2016: ITV ?

Summary

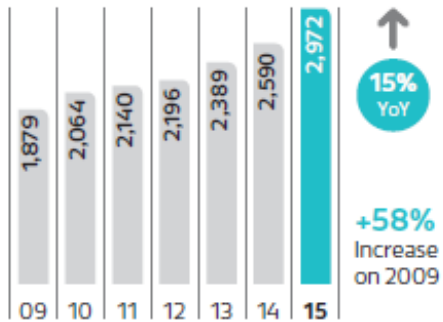
- Highly cash-generative business
- Diversified and improving business model
- Strong balance sheet
- Significant growth opportunities
- Very well managed and shareholder-oriented
- Brexit-depressed valuation

ITV at a glance

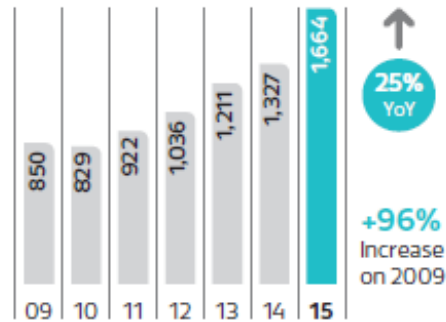
- Broadcast & online
- ITV Studios
- Changing business balance

Basic numbers

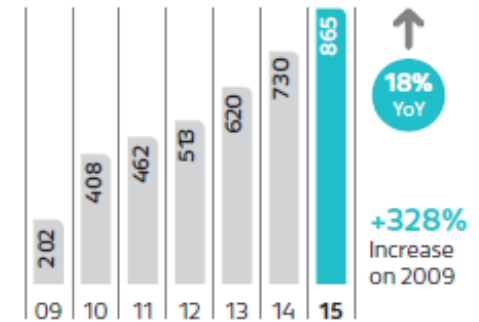
Group external revenue £m
£2,972m



Non-NAR revenue¹ £m
£1,664m



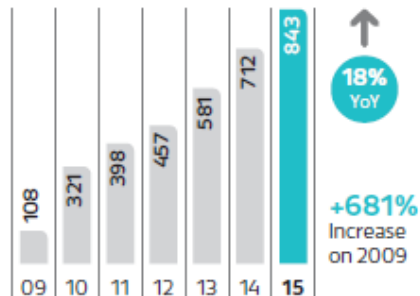
Adjusted EBITA² £m
£865m



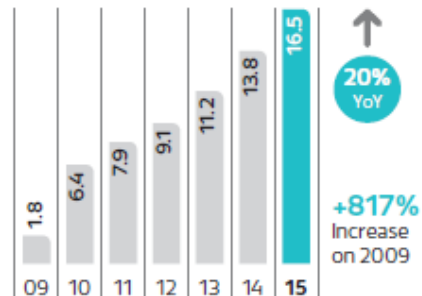
Source: ITV, Annual Report

Basic numbers

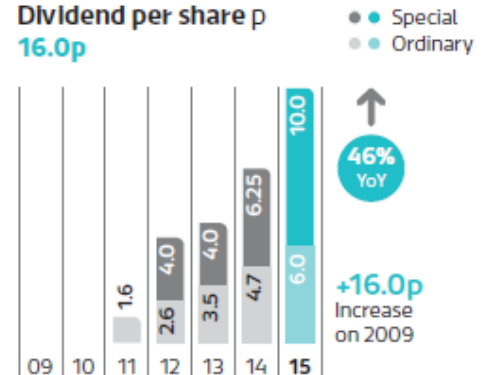
Adjusted profit before tax³ £m
£843m



Adjusted EPS⁴ p
16.5p



Dividend per share p
16.0p



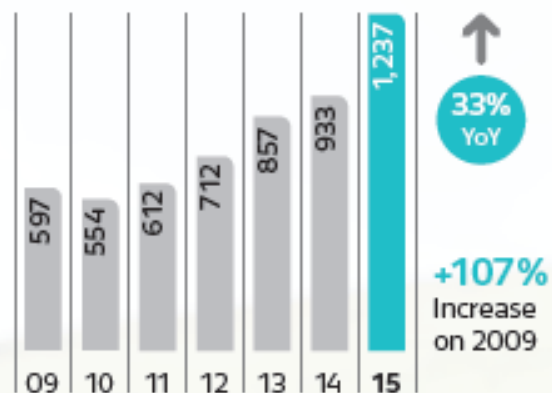
Source: ITV, Annual Report

ITV's strategy

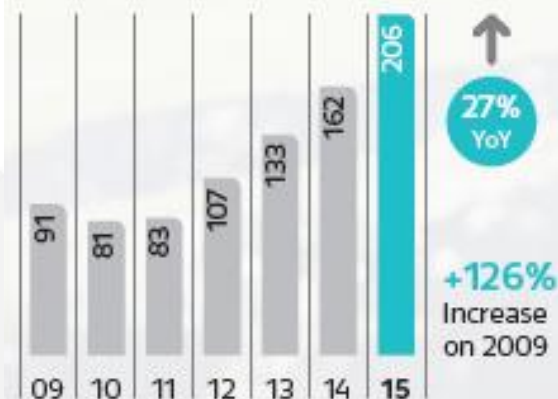
- MAXIMISING – Maximise audience and revenue share from free-to-air broadcast and VOD (video on demand) business.
- GROWING – Grow international content business.
- BUILDING – Build global pay and distribution business.

ITV's revenue growth, EBITA growth

Studios revenue growth £m
£1,237m

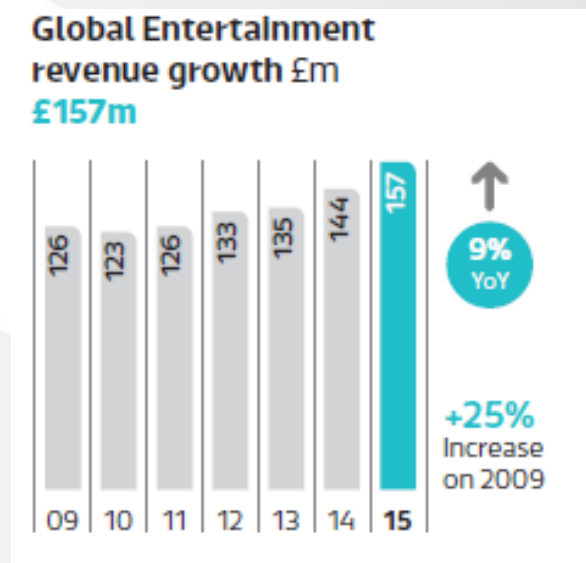
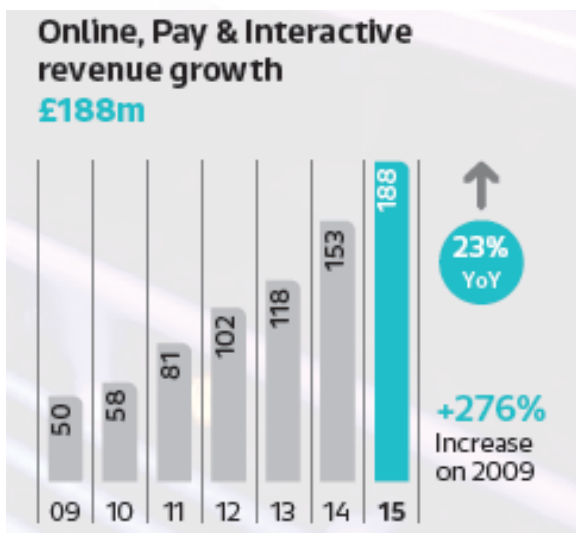


Studios adjusted EBITA growth £m
£206m



Source: ITV, Annual Report

Segments growth



Source: ITV, Annual Report

A few notes on acquisitions, debt, the CEO and the largest shareholder

Key industry themes

- The death of TV
- Viewing through apps
- Time shift
- The overwhelming rise of Netflix

Response

- Content
- Consolidation
- Direct offering
- Diversification of business models

Valuation

ITV 181

mil GBP	2014	2015	2016	2017	2018
Revenues	2590	2972	3080	3070	3160
Net income	554	659	660	630	670
EPS	13,83	16,45	16,42	15,67	16,67
Free cash flow	528	494	580	540	670
FCF yield	7,3%	6,8%	8,0%	7,4%	9,2%
DPS	10,95	16	7,2	7,6	8
DY	6,0%	8,8%	4,0%	4,2%	4,4%
Net debt	-41	319	645	445	235
Net debt/EBITDA	-0,05	0,35	0,70	0,50	0,26
Leverage deficit		1057	740	883	1120
ROE	59%	62%	65%	60%	50%
ROCE	43%	44%	40%	36%	32%

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SBERBANK

Daniel Gladiš

European Investing Summit 2015



VLTAVA FUND

My previous presentations

- 2012: WH Smith +152%
- 2013: Total Produce +66%
- 2014: Catlin Group +43%
- OK, but a Russian bank?!

Sberbank

- The largest Russian retail bank
- 28.6% of aggregate banking assets
- 44.9% of retail deposits
- 37.7% of retail loans
- 32.7% of corporate loans
- 16,500 branches
- 137 million retail clients
- 1.1 million corporate clients
- 90,000 ATMs
- Also in CIS, CE Europe, Turkey, UK, US
- Equity 2,100 bln RUB (31 bln USD)
- Total assets 24,000 bln RUB (363 bln USD)

Why NOT to invest in Sberbank

- Country in deep recession
- Economy dependent on commodities
- Double-digit inflation and interest rates
- Restricted access to foreign capital markets
- Bad corporate governance
- Weak rule of law
- Controlled by government
- ...and it is a bank

The Real Stress Test

Imagine a western country with:

- 4% negative GDP growth
- 15% inflation
- 15% central bank discount rate
- Currency collapsing by 50%
- Corporations and banks are facing sanctions

How would banks perform? Would they survive? Would they need new capital?

Sberbank performance during the crisis

		1Q 2013	2Q 2013	3Q 2013	4Q 2013	1Q 2014	2Q 2014	3Q 2014	4Q 2014	1Q 2015	2Q 2015
Income statement highlights											
Operating income before provisions	in bln RUB	254.1	266.8	287.7	295.2	296.0	331.8	359.7	351.2	304.9	338.8
Pre-tax profit	in bln RUB	110.5	108.9	120.3	116	94.3	121.1	90.8	68	49.9	75.1
Net profit	in bln RUB	88.5	86	93.8	93.7	72.9	97.5	70.9	49	30.6	54.6
Balance sheet highlights											
Assets	in bln RUB	15,116	16,143	16,689	18,210	19,110	19,390	20,679	25,201	24,246	23,657
Total deposits	in bln RUB	10,325	11,156	11,258	12,064	12,566	12,601	13,210	15,563	15,816	15,850

Source: Company data

Sberbank multiyear performance

(Balance sheet)

bln RUB	2008A	2009A	2010A	2011A	2012A	2013A	2014A	2015E	2016E
Cash and CBR deposits	811	766	771	727	1,502	1,579	2,675	2,357	2,789
Corporate loans	4,019	4,266	4,872	6,577	8,228	9,796	13,779	14,267	15,896
Personal loans	1,261	1,178	1,320	1,806	2,837	3,748	4,847	5,014	5,587
LLR	-202	-580	-703	-662	-565	-610	-870	-1,228	-1,457
Net loans	5,078	4,864	5,489	7,720	10,499	12,934	17,766	18,054	20,025
Securities	494	1,064	1,824	1,626	1,970	2,141	3,602	2,873	2,946
Other assets	354	411	544	763	1,126	1,557	1,136	1,596	1,629
Total assets	6,736	7,105	8,629	10,835	15,097	18,210	25,201	24,880	27,389
Due to banks	303	54	135	532	1,452	2,111	3,640	2,167	1,950
Customer deposits	4,795	5,439	6,651	7,932	10,179	12,064	15,563	16,577	18,869
Corporate deposits	1,683	1,652	1,817	2,206	3,196	3,628	6,235	6,484	7,262
Personal deposits	3,112	3,787	4,834	5,726	6,983	8,436	9,328	10,093	11,607
Issued debt	298	240	444	513	1,161	1,353	1,839	1,346	1,380
Subordinated debt	536	519	304	304	385	425	770	770	770
Other liabilities	54	74	108	286	296	376	1,369	1,792	1,837
Total liabilities	5,986	6,326	7,641	9,567	13,474	16,329	23,181	22,652	24,806
Equity	750	778	983	1,264	1,611	1,881	2,020	2,223	2,579
Total liabilities and equity	6,736	7,105	8,629	10,835	15,097	18,210	25,201	24,880	27,389

Sources: JP Morgan, Company data

Sberbank multiyear performance

(Balance sheet summary and ratios)

bln RUB	2008A	2009A	2010A	2011A	2012A	2013A	2014A	2015E	2016E
Equity/assets	11.0%	11.0%	11.0%	12.0%	11.0%	10.0%	8.0%	9.0%	9.0%
Deposits/liabilities	80.0%	86.0%	87.0%	83.0%	76.0%	74.0%	67.0%	73.0%	76.0%
Loans/deposits	106.0%	89.0%	83.0%	97.0%	103.0%	107.0%	114.0%	109.0%	106.0%
Tier 1 capital	708	724	898	1,181	1,474	1,788	1,920	2,113	2,451
Tier 2 capital	396	416	367	371	465	478	770	770	770
Total capital	1,104	1,141	1,265	1,552	1,940	2,267	2,689	2,883	3,221
Risk weighted assets (mln USD)	5,842	6,304	7,527	10,217	14,146	16,947	23,311	23,014	25,335
T1 CAR	12.1%	11.5%	11.9%	11.6%	10.4%	10.6%	8.2%	9.2%	9.7%
T2 CAR	6.8%	6.6%	4.9%	3.6%	3.3%	2.8%	3.3%	3.3%	3.0%
Total CAR	18.9%	18.1%	16.8%	15.2%	13.7%	13.4%	11.5%	12.5%	12.7%

Sources: JP Morgan, Company data

Sberbank multiyear performance (IFRS Income statement)

bln RUB	2008A	2009A	2010A	2011A	2012A	2013A	2014A	2015E	2016E
Interest income on loans	582	753	682	742	1,037	1,193	1,500	2,070	2,190
Interest income on securities	38	62	114	109	120	143	169	242	202
Interest expense	-242	-312	-317	-290	-453	-616	-785	-1,277	-1,130
Net interest income	378	503	479	561	705	719	851	1,001	1,222
Fees and commission income	86	101	124	141	170	220	282	337	360
Trading and other income	-15	44	47	35	46	21	-1	53	32
Non-interest income	71	145	171	175	216	242	281	390	392
Revenue	450	648	650	736	921	961	1,132	1,390	1,614
Provisions	-98	-389	-154	1	-22	-134	-361	-499	-439
Staff costs	-133	-129	-161	-201	-246	-285	-319	-339	-382
Depreciation	-21	-29	-32	-42	-52	-55	-59	-62	-64
Other costs	-68	-72	-72	-98	-154	-164	-188	-204	-230
Total operating costs	-222	-229	-266	-342	-451	-504	-565	-605	-675
Pre-taxprofit	130	30	230	396	448	323	374	286	500
Taxes	-32	-5	-48	-80	-100	-94	-84	-73	-102
Net income	98	24	182	316	349	362	292	213	398

Sources: JP Morgan, Company data

Sberbank multiyear performance

(IFRS Income statement summary and ratios)

	2008A	2009A	2010A	2011A	2012A	2013A	2014A	2015E	2016E
Spread	6.5%	7.4%	6.2%	6.0%	5.7%	5.5%	5.3%	3.9%	4.7%
Net interest margin	6.8%	7.7%	6.5%	6.2%	5.9%	5.6%	5.2%	4.4%	5.2%
Adjusted net margin	21.7%	3.8%	28.0%	42.9%	37.9%	37.7%	25.8%	15.3%	24.7%
Effective tax rate	-24.8%	-18.3%	-21.1%	-20.2%	-22.3%	-29.0%	-21.0%	-25.5%	-20.3%
Core revenue/total revenue	103.3%	93.2%	92.7%	95.3%	95.0%	97.8%	100.1%	96.2%	98.0%
Revenue growth	27.3%	44.2%	0.3%	13.3%	25.1%	4.4%	17.8%	22.9%	16.1%
Net income growth	-8.2%	-75.0%	646.6%	73.6%	10.3%	3.8%	-19.4%	-26.9%	86.7%
Cost/income ratio	49.0%	35.0%	41.0%	46.0%	49.0%	52.0%	50.0%	44.0%	42.0%
ROE	14.0%	3.0%	21.0%	28.0%	24.0%	21.0%	15.0%	10.0%	17.0%
ROA	1.7%	0.4%	2.3%	3.2%	2.7%	2.2%	1.3%	0.9%	1.5%

Sources: JP Morgan, Company data



VLTAVA FUND

Looking at normalized profitability

Based on the “New 5-Year Strategy for 2014–2018 “

Key figures:

- ROE 18–20%
- Tier 1 > 10%
- Cost / Income ratio 40–43%
- Assets 2018 / 2013 x 2

Estimating the next 3 years

Ratio Analysis @ RUB 74

	FY14A	FY15E	FY16E	FY17E	FY18E
Share and per share data					
Shares-common, eop (mln)	21,587	21,587	21,587	21,587	21,587
Shares-preferred, eop (mln)	1,000	1,000	1,000	1,000	1,000
EPS	12.92	9.45	17.64	23.88	27.7
BVPS tangible	89.24	98.24	113.99	133.89	154.67
Payout ratio	3.50%	20.00%	22.50%	25.00%	25.00%
DPS-common	0.45	1.89	3.53	4.78	6.93
Dividend yield-common	0.6%	2.6%	4.8%	6.5%	9.4%
Valuation and profitability ratios					
P/E	5.7	7.8	4.2	3.1	2.7
P/BV tangible	0.8	0.8	0.6	0.6	0.5
ROAE tangible	14.90%	10.10%	16.60%	19.30%	19.30%
ROAA tangible	1.30%	0.90%	1.50%	1.90%	1.90%
NIM	5.20%	4.40%	5.20%	5.30%	5.30%
Operating efficiency ratios					
Operating costs/Av. total assets	2.60%	2.40%	2.60%	2.60%	2.60%
Cost/Income	43.40%	43.50%	41.80%	41.00%	41.00%

Valuation

- 0.75x – 1.00x TBV 2018e: **116–154**
- 6x – 8x EPS 2018e: **166–221**
- Estimated 3Y return (incl. dividends)
- Low end: 74%
- Midpoint: 142%
- High end: 218%

Competitive advantages

- Low-cost deposit base
- Scale and cost/income ratio
- Higher NIM
- Higher ROA, ROE

Risks

- Geopolitical
- Macro
- Government
- Currency

Wild Card - International contraction

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Catlin Group

Daniel Gladiš, Director of Vltava Fund

European Investing Summit 2014

Why I like Catlin

- Relatively simple and understandable business
- Managed by its founder
- Clearly defined financial goals
- Strong historical track record
- Significant value creation for shareholders
- Attractively valued

Business

- International specialty property/casualty insurer and reinsurer
- Founded in 1984
- IPO in 2004
- Managed by Stephen Catlin (owns 2%)

Underwriting

Insurance

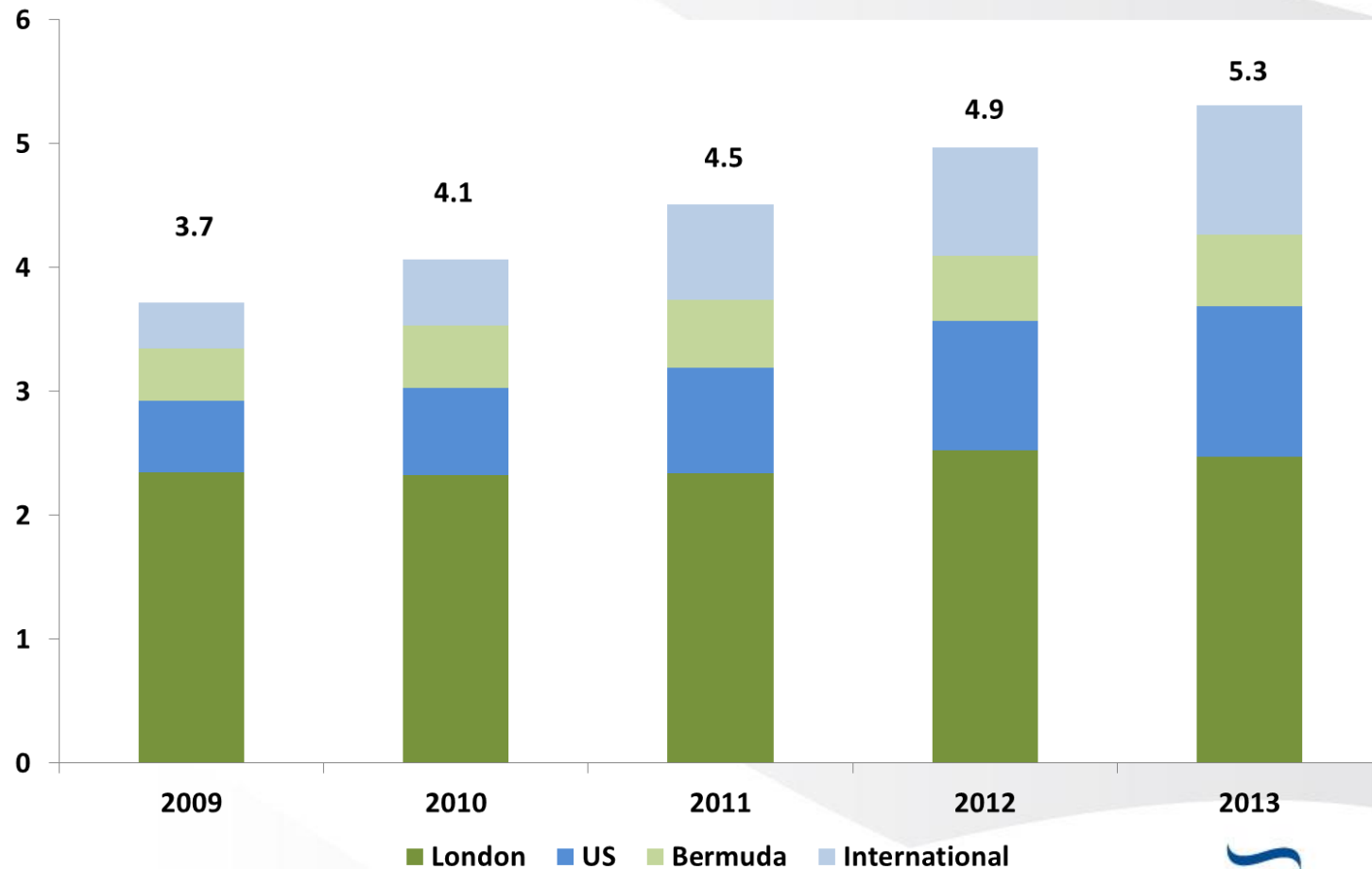
Aerospace
Casualty
Energy
Marine
Property
Specialty
War and political risk

Reinsurance

Agriculture
Bespoke
Casualty
Marine and aviation
Property
Specialty

Six underwriting hubs

Gross premiums written, USD billion



VLTAVA FUND

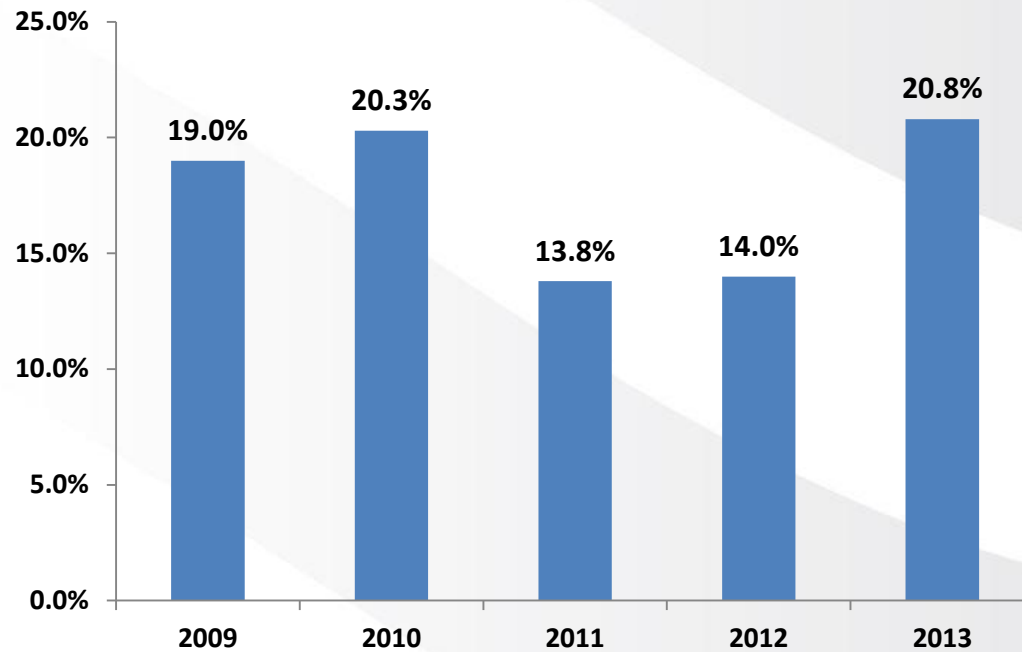
Underwriting results

		2009	2010	2011	2012	2013
Net underwriting contribution	USD mil	651	683	324	788	1,003
Loss ratio	%	57.6	57.5	70.0	56.0	52.3
Attritional loss ratio	%	53.7	51.6	50.0	50.6	50.1
Combined ratio	%	89.1	89.8	102.6	90.0	85.6
Gross premiums written	USD mil	3,715	4,069	4,513	4,972	5,309
Net premiums earned	USD mil	2,918	3,219	3,612	3,604	3,948

Reserve releases

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Release as % of opening reserves	5	8	1	5	4	3	3	2	3	3

Capital buffer



Catastrophe threat scenarios

	Florida (Miami) windstorm	California earthquake	Gulf of Mexico windstorm	European windstorm	Japanese earthquake
Modelled net loss as % of available capital	14	14	8	17	11
Estimated industry loss (USD billion)	125	78	112	31	51

Investing

		2009	2010	2011	2012	2013
Total cash and investment	USD mil	7,693	8,021	8,388	8,774	9,217
Stockholders' equity	USD mil	3,278	3,448	3,298	3,512	3,783
Investment leverage		2.35	2.33	2.54	2.50	2.44
Investment per share	GBP	11.12	12.61	12.85	12.85	13.10
Net investment return	USD mil	414	205	248	158	124
Net investment return	%	5.5	2.6	3.0	1.8	1.4



Asset allocation

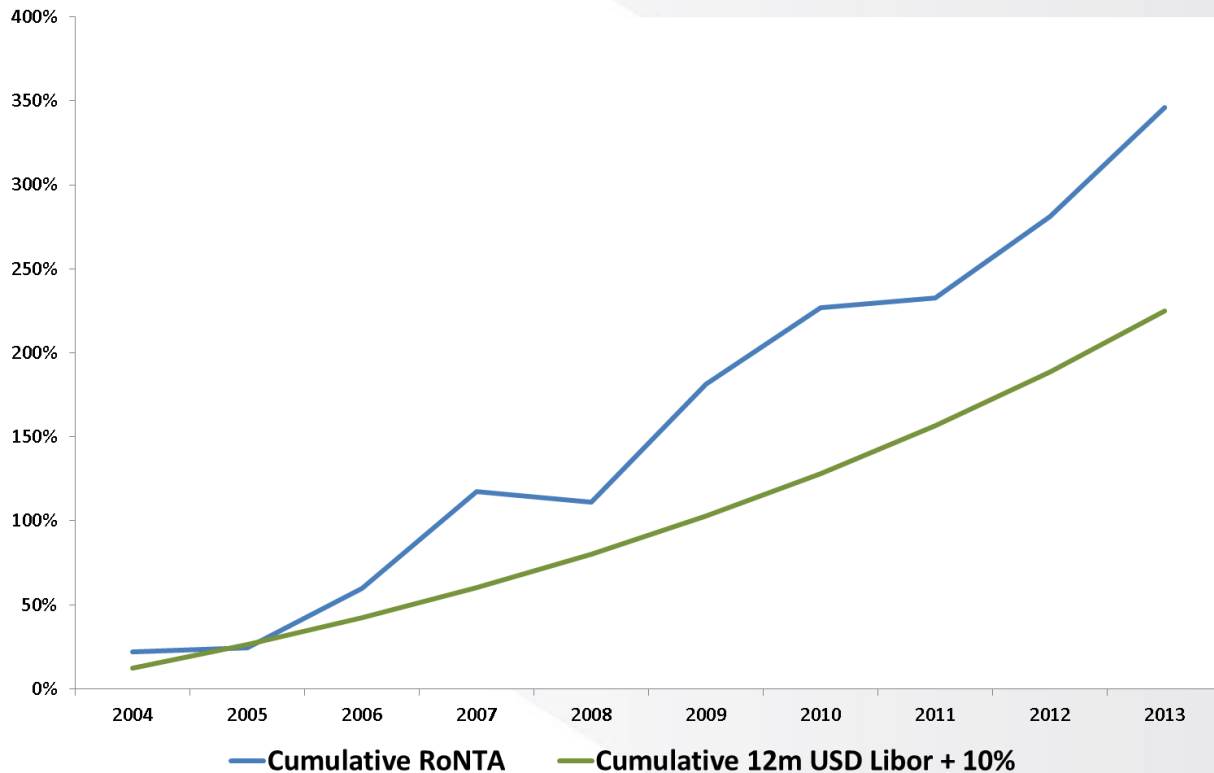
Detailed asset allocation	2013	2012
Fixed income investments		
US government and agency securities	6%	9%
Non-US government and agency securities	18%	17%
Agency mortgage-backed securities	6%	9%
Asset-backed securities	11%	8%
Covered bonds	6%	5%
Corporate bonds	17%	15%
Commercial mortgage-backed securities	1%	1%
Non-agency mortgage-backed securities	1%	0%
	66%	64%
Cash and short-term investments	27%	30%
Other invested assets	7%	6%
Total	100%	100%



Clearly defined financial goals

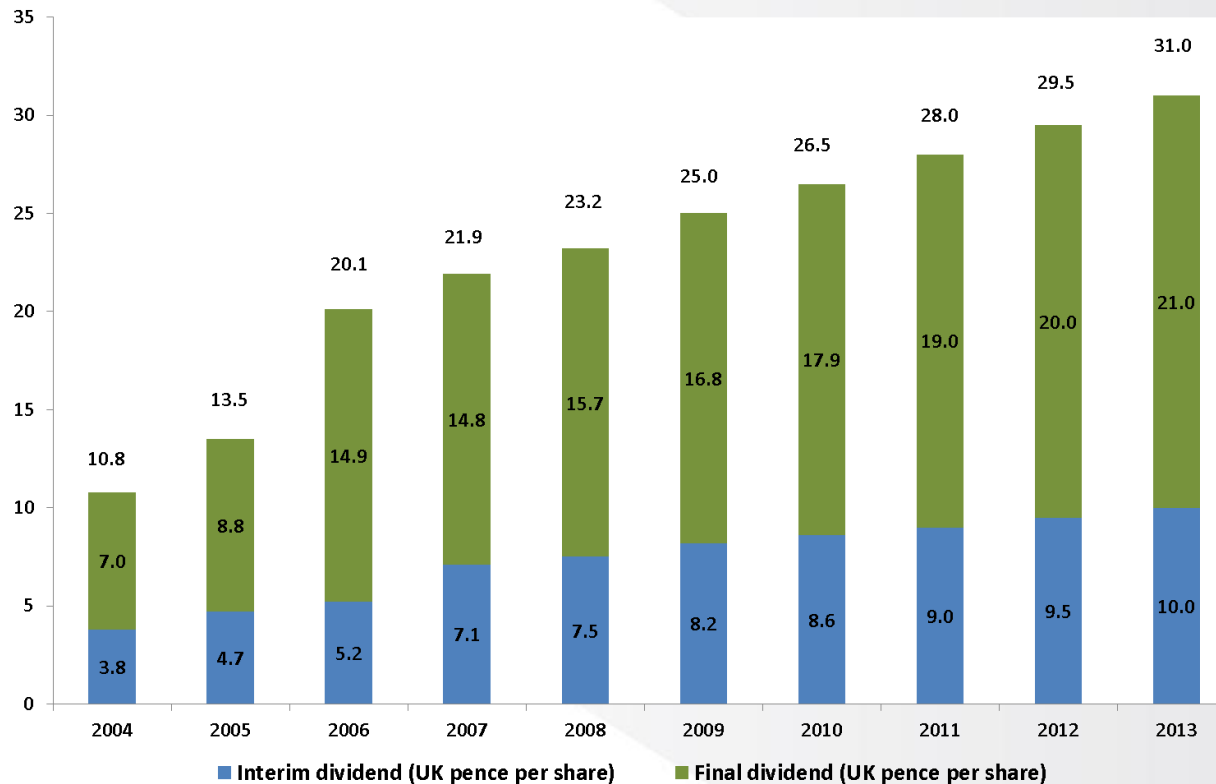
- Long-term progress measured by growth in book value per share
- Long-term goal is 12-month USD Libor + 10%

History since IPO



Average Catlin RoNTA during period:	16.8%
Average Catlin ROE during period:	13.2%
Average risk-free rate + 10%:	12.5%

Capital deployment



- Dividends since 2004: USD 1.2 billion
- Possible dividends 2014–2023: USD 2.5 billion
- Current market cap: USD 2.9 billion

Valuation @ GBP 515p

■ PE	8
■ PB	0.9
■ PTB	1.1
■ DY	6.1%

Further points of importance

- What is the source of a competitive advantage (if any)?
- Alternative capital threat
- Low investment returns

Closing summary

- Well run straightforward business
- Low correlation with the economic cycle
- Leveraged to higher interest rates
- Cheap



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EUROPEAN INVESTING SUMMIT

Total Produce – a little known, solid business

Daniel Gladiš

Vltava Fund

October 8th – 9th, 2013





(LSE:TOT , ISE:T7O; Price EUR 0.78)

SUMMARY:

- Low-risk business model
- Consistent and resilient
- High free cash flow generator
- Management ownership
- Almost uncovered by brokers
- Attractively valued

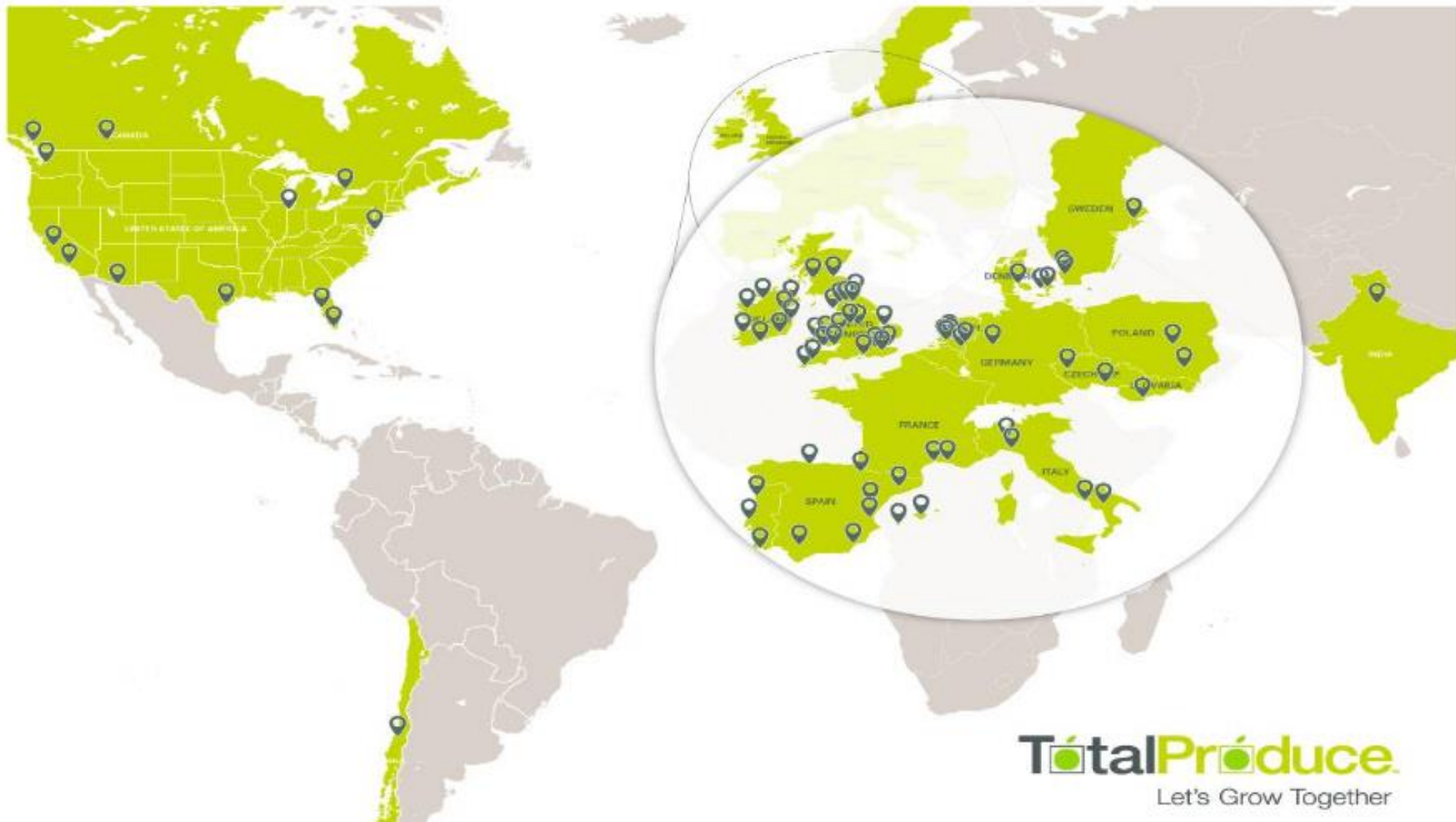
The Business

A large B2B operator in a specialist sector

Sourcing, marketing, distributing, packaging

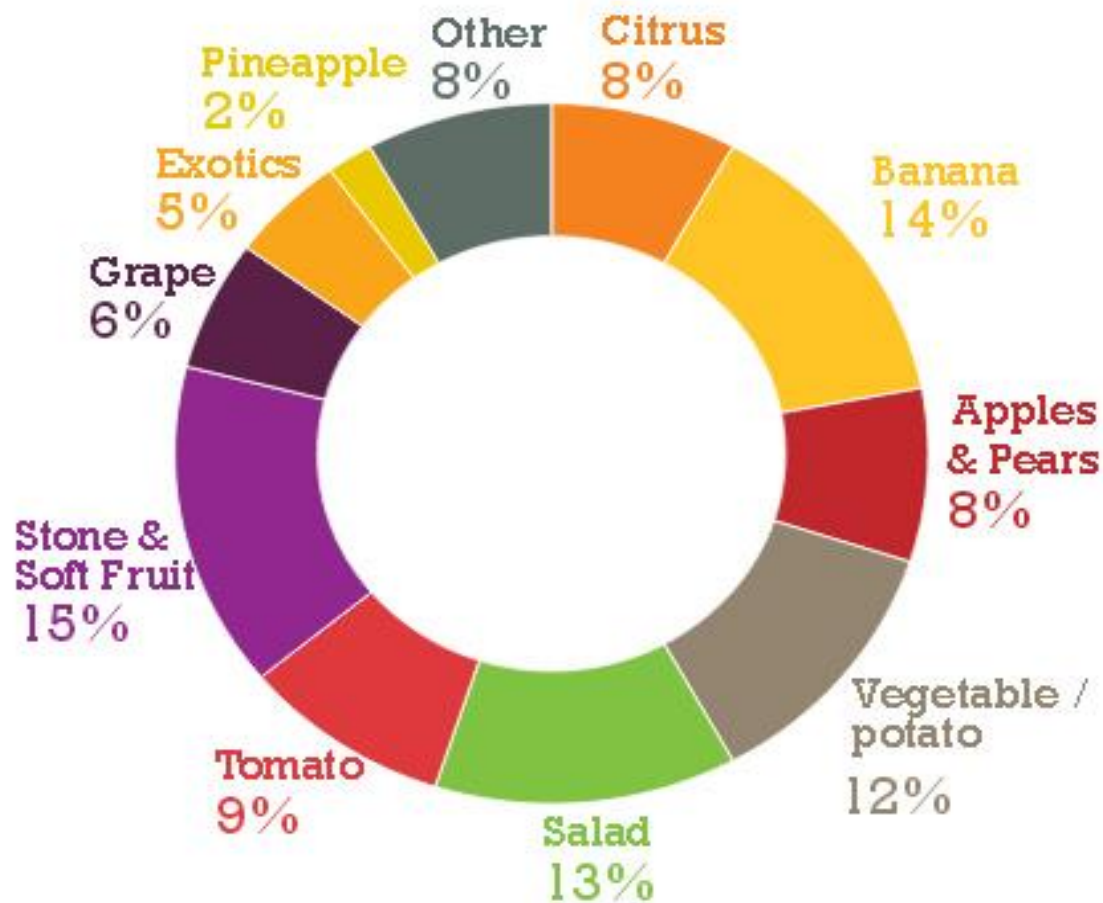
Very resilient and stable business

Principal Locations



Source: Company presentation

Our Produce Portfolio



Source: Company presentation

Revenue and EPS progression since the demerger

	2006	2007	2008	2009	2010	2011	2012	2013 E
Revenue in mil €		2 431	2 516	2 431	2 600	2 527	2 811	2 840
Adj EPS in cents	5.75	6.46	6.78	6.46	6.84	7.24	8.11	8.80
Growth yoy %		12.3	4.9	(4.7)	5.9	5.8	12.0	8.5

Source: Company reports

Cash flow since demerger I.

(in mil €)	2007 - 2012
Operating cash flows	261
Maintenance capex	-44
Dividends from JVs & Associates	13
Dividends to non-controlling interests	-29
Total free cash flow	201

Source: Company reports

Cash flow since demerger II.

(in mil €)	2007 - 2012
Total free cash flow	201
Disposals	14
Acquisitions	-128
Development capex	-35
Share buyback	-41
Other	-2
Change in net debt	-9
Net debt at January 1st 2007	-62
Net debt at December 31st 2012	-53

Source: Company reports

Acquisitions since demerger

Date	Company	Deal Value	EV / Sales
Dec 2012	The Oppenheimer Group	40.5 m USD	0.1 x
Jul 2012	Indigo Fruit SAS	-	-
Jun 2012	R.E. Dennis & Son Ltd.	-	-
Dec 2011	Frankort & Konig BV	15 m EUR	0.1 x
Oct 2010	Groomes The Fresh Food Co.	-	-
Nov 2009	Utopia UK Ltd.	-	-
Apr 2009	ASF Holland BV	-	-
May 2008	Haluco BV	-	-
May 2008	Nedalpac BV	-	-
Jul 2007	Wholefoods Wholesale Ltd.	-	-
Jan 2007	Redbridge Holdings Ltd.	15.6 m GBP	0.1

Source: FactSet

EV/EBITDA

in mil €	2012	2013 F	2014 F
Group EBITDA inc. share of associates/JVs	70 678	72 862	76 854
Group EV	346 467	378 681	367 882
Group EV / Group EBITDA	4.9x	5.2x	4.8x

Source: Davy, company reports

2014F EV/EBITDA sensitivity analysis (net of investments in associates/JVs)

2014F EBITDA (in mil €)	64.67	64.67	64.67
EV/EBITDA multiple	5.0	5.5	6.0
Implied EV	323.3	355.67	388.0
Less forecast total net debt	-69.0	-69.0	-69.0
Less minority interests	-64.2	-64.2	-64.2
Add back investments in associates/JVs	73.3	73.3	73.3
Implied equity value	263.5	295.8	328.2
Price per share (in cents)	79.9	89.7	99.5
Potencial upside (incl. dividend)	7.9 %	20.5 %	33 %
Implied PE (at EPS 9.3 cents)	8.6	9.6	10.7

Source: Davy

ROIC / WACC and EV / IC analysis

	2007	2008	2009	2010	2011	2012	2013 F	2014 F
ROIC (after tax) %	11.5	11.6	10.7	10.8	10.0	11.1	10.6	10.3
WACC %	7.9	8.0	7.6	7.3	7.2	7.0	6.7	6.6
ROIC/WACC	1.46	1.45	1.41	1.48	1.39	1.59	1.58	1.56
EV / IC	1.19	0.73	0.81	0.82	0.79	0.95	0.99	0.92

Source: Davy

Free Cash Flow Generation

Free Cash flow generation 2007-2013

EUR 201 mil, i.e. historical average FCF yield of 12,5 %

Current FCF yield closer to 14 %

FCF yield of 10 % would point to price of 110 cents

Summary

- Market leader with a strong balance sheet
- Experienced management with ownership
- Solid and resilient business model
- Attractively valued

EUROPEAN INVESTING SUMMIT

WH Smith – Boring Beauty

Daniel Gladiš

Vltava Fund

October 9th – 10th, 2012



WH SMITH plc
(LSE: SMWH)



- Swindon, England 
- UK LEADING RETAILER:
 - BOOKS
 - STATIONERY
 - NEWSPAPERS
 - MAGAZINES

PRESENTATION CONTENT

- SUMMARY
- BUSINESS DESCRIPTION
- OPERATIONS
- QUALITIES
- GROWTH PROSPECTS
- FINANCIALS
- MANAGEMENT

SUMMARY

- STRONG BRAND
- CONSISTENT PERFORMANCE
- LOW CAPITAL INTENSITY
- STRONG FREE CASH FLOW
- SHAREHOLDER FRIENDLY CAPITAL ALLOCATION
- LOW VALUATION

BUSINESS DESCRIPTION

- TRAVEL
- HIGH STREET
- ONLINE

TRAVEL

- 561 UNITS (136 franchises):
 - 142 Airports
 - 125 Railway Stations
 - 119 Motorway Service Areas
 - 111 Hospitals
 - 32 Workplaces & Bus Stations

TRAVEL

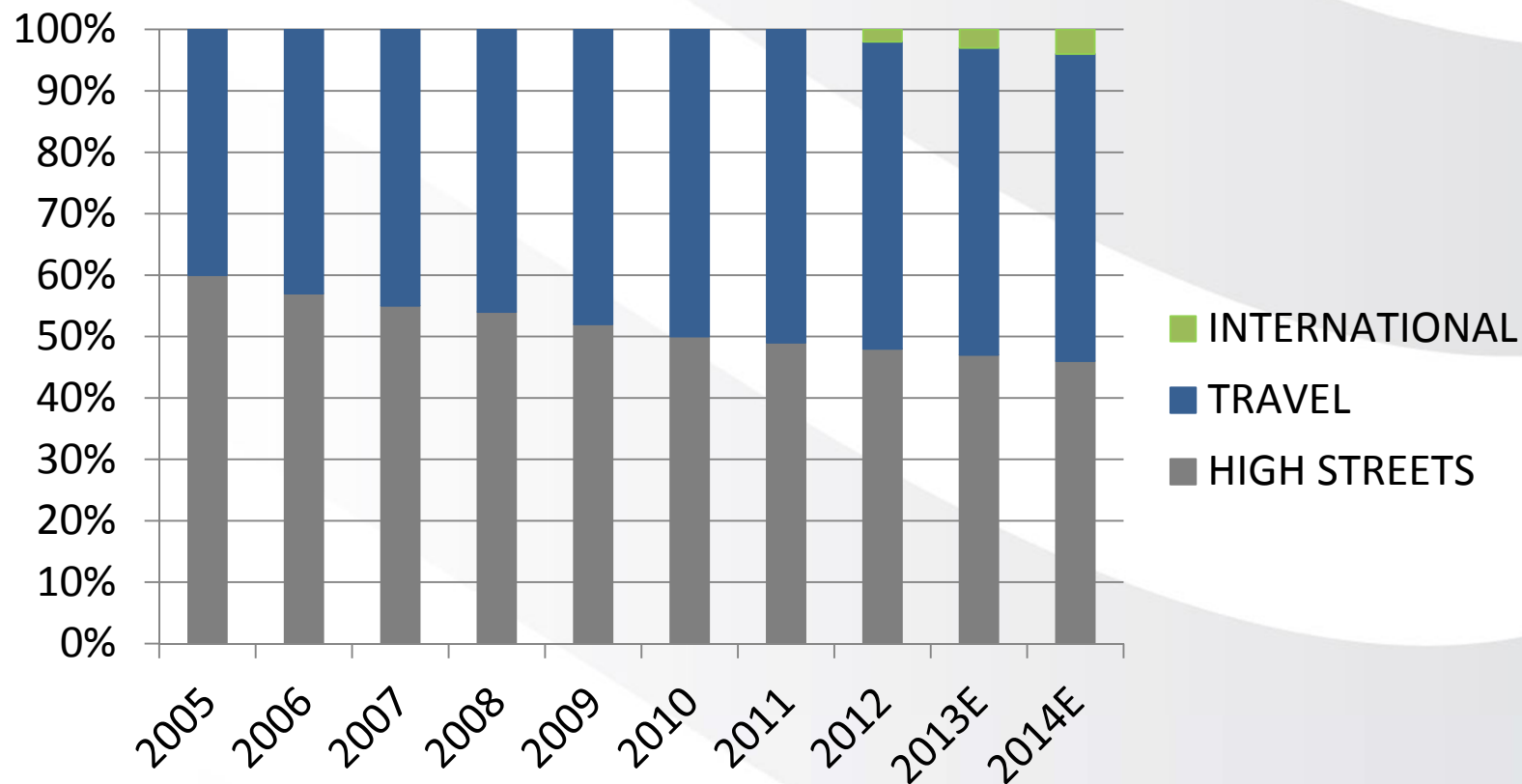
- 32 UNITS NON UK:
 - Ireland
 - Denmark
 - India
 - Australia
 - Oman

HIGH STREET

612 UNITS IN ALMOST ALL UK'S MAJOR HIGH STREETS

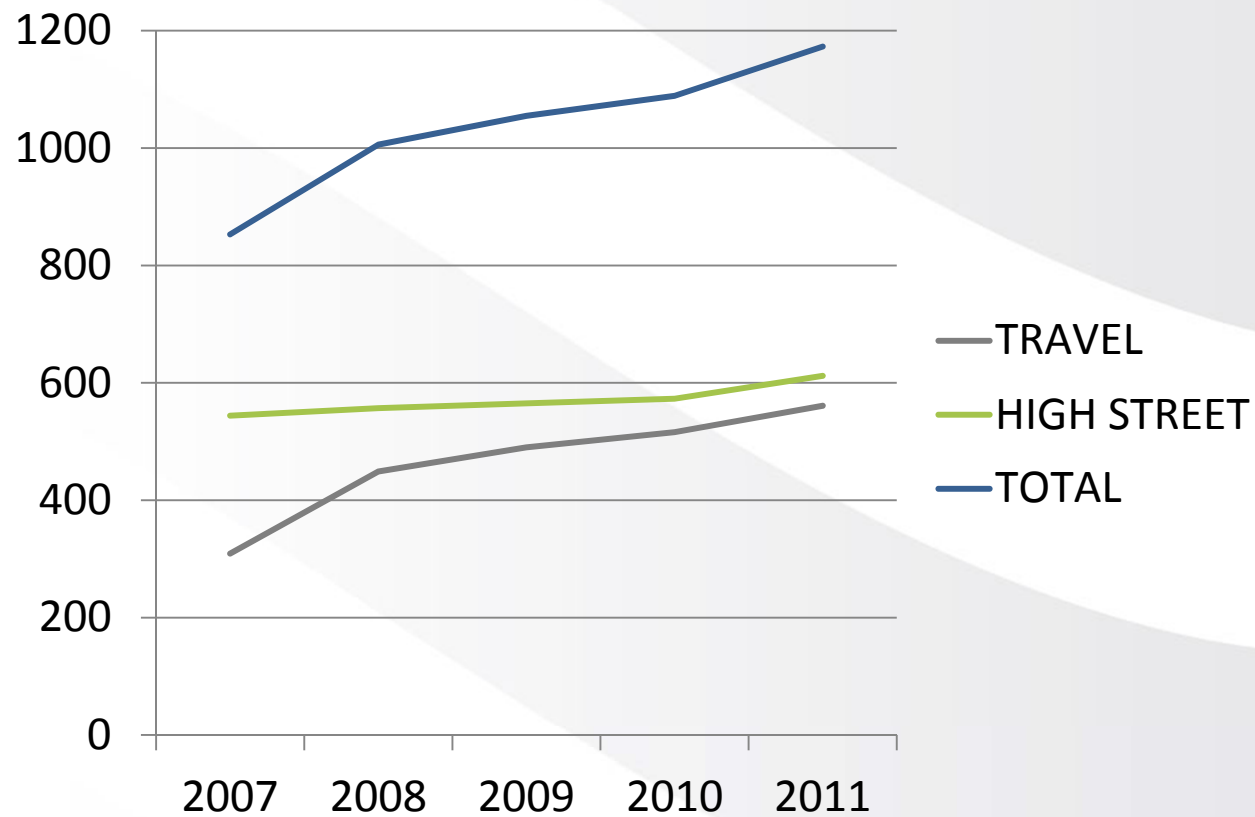


OPERATING PROFIT SPLIT



Source: City Investment Research and Analysis

NUMBER OF UNITS



Source: WH Smith

COMPETITIVE POSITION & STRENGTHS

- BRAND
- LOCATION
- PURCHASING & SOURCING SCALE
- COST EFFICIENCY

GROWTH PROSPECTS

TRAVEL & INTERNATIONAL



KEY FIGURES

	SALES	NET PROFIT	EPS <small>SHARE PRICE: £613 on 17th September</small>	DEBT	FREE CASH FLOW	DPS <small>SHARE PRICE: £613 on 17th September</small>	CAPITAL RETURNED <small>(DIVIDEND + BUYBACKS)</small>
	£m	£m	p	£m	£m	p	£m
2007	1299	60	29	0	81	12	17
2008	1352	59	35	9	63	47	111
2009	1340	64	41	0	108	17	31
2010	1312	69	46	0	99	19	61
2011	1273	73	51	0	84	23	84
2012E	1252	81	61	0	99	26	83
2013E	1259	86	71	0	107	30	77
2014E	1279	91	80	0	113	34	79

Source: Company Reports and CIRA Estimates

MANAGEMENT

- EXPERIENCED MANAGEMENT
- MOTIVATED MANAGEMENT

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EXCELLENT CAPITAL
ALLOCATION



SUMMARY

- CONSISTENT & GROWING BUSINESS
- NO DEBT
- HIGH FREE CASH FLOW
- EXCELLENT CAPITAL ALLOCATION
- EXPERIENCED & MOTIVATED MANAGEMENT