VLTAVA FUND

A LACK OF SEX

Dear shareholders
In the second quarter of 2015 the Fund's NAV decreased by 2.4%.

The alternative scene

In my previous letter to shareholders, I wrote about the bubble in bond prices. Although their prices have since turned downward – and at times quite significantly – they remain ridiculously high. Today I want to focus in on some other asset types. These are sometimes referred to collectively as "alternative" investments, and this might create an impression that they are something above standard. According to those who promote them, alternative assets also require alternative approaches to their valuation. **In fact, however, it applies to all investments – whatever label we put on them – that their value equals the present value of their future cash flows and that the relationship between price and value is decisive.**

Markets in general have a cyclical nature, and when the cycle is in its upper phase there begin to appear signs of maturity that include certain side effects. Generally, prices are higher, investment opportunities fewer, and the access to cash cheaper and easier. On the investors' side, meanwhile, we see underestimation of risks and frequently the investors' mistaking the results of a bull market several years in the running as evidence of their personal ingeniousness. On the side of companies offering financial products, there is a never-ending cleverness and capability to exploit this situation and to sell everything they can. Unsuspecting investors then venture into things they do not understand in the least but nevertheless feel good inasmuch as they took an alternative route.

Private equity

It seems almost everybody and his brother is founding a private equity fund these days. The word private sounds nice. Everything private is good, is it not? This word has a different meaning in this context, however. It is used in contrast to the word public and means that these are investments into shares (equity) of companies that are not publicly traded. So, what are their advantages? These shares have low liquidity and their pricing is not transparent.

The basic idea of private equity is to buy controlling shares in companies, then manage them for some time, and finally, utilising large quantities of debt, either bring them to the public market or sell them on to a third party. **Private equity sounds alternative and appealing. A more accurate name for this, however, would be "leveraged investments into untransparently priced and illiquid shares".**

But what is so important about liquidity and transparency? We could sell 90% of the Vltava Fund portfolio at any time within a single day while not influencing the prices of the shares we hold. Even though we are long-term investors and our investment horizon is 5 years and more for the individual investments, high liquidity has its option value. A situation can arise wherein this will be invaluable. The liquidity of private equity investments is exceedingly low, and in certain more critical periods it is practically zero. Little wonder, then, that private equity funds are constructed as closed, which means that investors cannot leave the fund for a number of years. As things go in life, the inaccessibility of one's money in private equity investments usually appears to be a handicap only at such time as one most needs it.

If we at Vltava Fund hold, for example, Walmart shares, then there cannot be the slightest doubt as to what is their price. One needs only to look at the market. We can have our own idea as to what is their intrinsic value and what their price should be, but a market price is always used for valuation. We have no influence on it, and it is therefore entirely transparent. This valuation method is called "marking to market". Private equity funds cannot use it, because their companies' shares are not traded anywhere. They are using the "mark to model" method, and that means that they value the companies in their portfolios according to some model. Even though they always avow that this is an independent, expert, and fair approach, this assertion is wholly open to dispute. First, the models used are either the private equity firms' own internal ones or those of companies they hire and pay. There is no independence. Second, there is no objectively defined company value. This will always be a subjective and imprecise estimate. Here, creativity knows no bounds. For example, a multiple of the company's EBITDA is very frequently used in the value calculation. **Every professional investor knows very well that EBITDA is a wholly nonsensical indicator in this respect, and that it is used either by those who do not know what they are doing or by those who know precisely what they want to achieve by using it. "Mark to model" then frequently transforms to "mark to fantasy".**

Low liquidity and low transparency cannot be denied. What arguments do sellers of private equity use to balance these out? Essentially they use three arguments.

First, they maintain that they can find excellent companies and then manage them excellently. Everyone says that, but this is not quite so easy in practice. Offering a financial product and managing a company are two entirely different things requiring wholly different skills. In my career, I have done both and I think I can judge that a little. I do not want to wrong anyone, however, and I concede that some people have both sets of skills. The question is, however, whether investors into private equity firms can know that in advance. When I imagine how many excellent companies with demonstrably excellent managers are traded on public markets, it seems to me almost futile to venture half-blind into private equity.

Second, private equity investments are allegedly less volatile and therefore less risky. Of course, if the sellers of private equity funds value their investments using their own models, then their valuations will certainly be less volatile than, for instance, those given by the equity market. But then we are comparing apples to oranges and reality to dreams. When during 2008–2009 equity markets fell by a half, what happened to prices of investments held by private equity firms? They fell by at least as much, and in many cases they became entirely unsellable. **The fact that this had no effect on the valuation models of private equity firms is no proof of a less volatile business; rather, it proves that valuation methods had diverged from the market reality.** In addition, I believe that its working with substantial debt makes private equity much more volatile and risky than it is presented to be.

Third, private equity allegedly brings higher returns. That may be true for the managers of those funds but not for their investors. The fee structure, long--term closed character of private equity funds, and assets valuation using their own models create a great asymmetry of returns. When the fund fares well, its managers collect a large proportion of the returns; when the fund fares badly, the investors bear the losses.

The business model of a private equity fund is usually based on several crucial steps: Promise unrealistically high returns, collect the investors' money and lock it in for as long as possible, and set up the fee structure so that the managers have guaranteed high returns almost without regard for how successful they are. That is the sad reality. For the first several years, when the assets are valued in accordance with internal models, good returns – at least on paper – can be counted upon. And when push comes to shove and it perhaps appears that returns are much lower than promised, there is always some trick up the sleeve to cover it. Such as by diluting the failure with new money from unsuspecting investors. The show must go on!

Farmland

In recent years, there has been a literal mania to grab up farmland in the Czech Republic. The main arguments are as follow: the price of land is always rising, its price is low in comparison to Austria, and the amount of land does not increase. Such arguments can scarcely be resisted. It is not true, however, that the price of land is continually increasing. All one has to do is to look at other countries and into history to find very soon that not only do the prices of land not always rise, but, from time to time, they also decline – and even significantly so over the long term. Yes, land is cheaper in the Czech Republic than, for example, in Austria, but it is not exceptional in history for apparently comparable assets to be valued differently even for decades. While it is true that the amount of land does not increase, the crop yields derived from it do, and at the same time the number of people in Europe is decreasing. So perhaps even the point about its amount not increasing is not so clear-cut. In any case, the value of an asset does not depend on whether its amount increases or does not, but on the returns that it brings.

Returns from farmland are very low in the Czech Republic, on the order of 2.5–3% per year. After tax, therefore, we get a level of about 2%. That is not much. Paying 50 times the annual profit for an asset is quite a lot. Let us consider just for the sake of comparison that equity markets are considered to be rather expensive today even though as a price multiple of annual returns they only are about one-third so high. Equity indices would need suddenly to triple for equities to be as expensive as is farmland in the Czech Republic.

Nevertheless, a 2% return can seem sufficient to someone in the light of low interest rates. **What happens to land prices, however, if for example interest rates return to their normal non-deformed level? The investors will demand higher returns from land, let us say 6–7%. This can be achieved in two ways: by a more than doubling of the rental price or a marked decrease in the land price.**

Critical comments on investments into private equity concerning low liquidity, low transparency and valuation on the basis of models also apply for investments into farmland. Nevertheless, they are very popular in the Czech Republic. We should remember one wise rule, however, and that is when a majority of investors are convinced something is a good investment, then it probably no longer is.

High-yield bonds

The name high-yield bonds is only a euphemism for bonds issued by high-risk debtors. In English, they have the beautiful nickname junk bonds. When interest rates are zero, any bond yielding more than 5% looks tempting, and in the Czech Republic they have been on a tear. **Investors may not realise, however, what is the greatest risk connected to them – and that is the risk that the bond will not be repaid.** This risk exists for every bond, and the size of that risk should be weighed against the amount of its return. Investors are usually unable to judge this risk by themselves, and, truth be told, they mostly do not even try very hard to do so. They are blinded by the fixation on yield. However, the level of yields for bonds in this category today does not at all offset the risk undertaken. This is given by the record-low rates on government bonds and at the same time record-low spreads between these and high-yield bonds. When we sum these two numbers, we get a total yield on junk bonds which is lower than what under normal circumstances would usually be their spread return alone.

Everything is interrelated

The price levels of the individual asset classes do not develop in a vacuum. Rather, they are mutually related. If we consider equity markets to be rather expensive, then it would be naïve to believe that this would not affect the prices of private equity investments. If interest rates are low and money is generally easily available, then it would be naïve to believe that it would not affect prices for land. And if government bonds are undeniably in a price bubble, then it would be naïve to believe that this does not impact upon high-yield bonds.

A lack of sex

Warren Buffett has remarked that in 1974 he felt like an oversexed man in a harem. Equity prices were so low that he literally did not know where to invest first. **Today it seems to me that some investors are behaving as though, by contrast, they have had a chronic lack of sex. They take almost anything regardless of price.**

We never want to reach this state. We endeavour to stick to what is in our circle of competence – publicly traded equity. The possibilities offered by this market are immense. In addition, our investments are very highly liquid and transparent. You know which companies we own and you can also follow their development yourselves.

I do not hold a patent on brains, and I am aware that I can be wrong about many things. Nevertheless, I have been active in the markets for almost a quarter century and I can see certain things repeating again and again. As investors, you pay us for taking care of your money and, indirectly, for saying what we think. Perhaps this letter will help you in your own investment deliberations. When I consider the individual investments, I frequently ask myself what Buffett would do. When you find yourself tempted to take some alternative route, you might try that as well. It helps.

Changes in the portfolio

We sold nothing and we have two new positions. One is a company in the financial sector, and its business is based on intermediating transactions without the risk of trading on its own account and without great need for its own capital. The company's free cash flow is at an inflection point and it should bring nice returns for many years to come.

The second company produces specialty industrial goods. It is a company with a very strong position as well as a distinct and persistently sustainable competitive advantage. We have been following it for many years, and we finally saw the long-awaited drop in price and good buying opportunity.

In addition to these two new positions, we have significantly expanded one of our existing European positions. At times an even irrational paranoia prevailing on the market due to developments in Greece brought excellent prices and we have taken advantage of these accordingly. I would almost like to thank the Greek government for helping create such investment opportunities. Apparently, this will not be the last such opportunity…

Daniel Gladiš, July 2015