VLTAVA FUND

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 waken 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 dearness 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.

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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-ŕ-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 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.

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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.

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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.

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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