FORM FOLLOWS FUNCTION

Dear shareholders,

In the first quarter of 2014, the Fund's NAV grew by 7.3%.

Form follows function

Once upon a time long ago (in fact, more than a quarter century ago), I entered the Faculty of Civil Engineering at the Brno University of Technology. That was still in the times of Communism, when essentially neither finance as a field of endeavour nor financial markets yet existed in our country. By the time I had completed my studies a year and a half after the Velvet Revolution, the world here had suddenly and completely changed. I left my five years of studies behind and set out into the fascinating world of finance.

It might appear as if my degree in civil engineering means nothing to me, because it was clear that I would not use it to earn my living. But all education has value in its own right, and even fields appearing to be completely unrelated can have a great deal in common. That may be true even of civil engineering and investing. Or, to put it more precisely, of architecture and investing.

At the close of the 19th century, the face of a great city had been taking shape in Chicago. While skyscrapers are typical for New York, it was Chicago which determined the direction in which they would develop. And so it was in Chicago at that time that the phrase "form follows function" originated and came into use. In architecture, it means that a given building's shape and structure should be determined by the function which the building is to perform. This was the fundamental idea from which the architectural style of functionalism would later evolve. Although the idea was fundamental, it perhaps was not wholly original, as similar reflections had been recorded already in the times of ancient Rome when Vitruvius had written that every building should be robust, useful and beautiful.

And what has all this to do with investing? The parallels ought to be clear. Every portfolio should take such form as properly corresponds to its function or its investment objective.

In order to achieve such a state, our first step must be to define the function that we want the portfolio to perform. In our case, the function can be stated, for example, as follows:

The portfolio's function is to deliver long-term, substantially positive real appreciation accompanied by minimal probability for permanent loss of capital.

Creating the form

This definition in fact encompasses three crucial functions of the portfolio:

1. **Long-term orientation**. Our objectives are unambiguously long term in nature. It can be said that we have no short-term objectives whatsoever, and, if we were to have such goals, we admit that we would not even know how to achieve them. In our approach, long-term orientation means at least several years.

2. **Positive real appreciation**. The investor's greatest enemy and at the same time his or her motivation is inflation. Day after day, it steals from the value of money. A function of the portfolio, therefore, must be to produce real returns, namely returns net of inflation.

3. **Minimal probability for permanent loss of capital**. This depends on more than just price but also on how an investment's value develops. It is precisely by choosing investments whose values grow over the long term (and acquiring these at low prices) that the probability for permanent loss of capital will be diminished.

Regarding individual classes of assets, the data clearly show that over the long term as well as over most medium-length periods equities are the assets which bring the greatest returns. If we define risk as the probability for permanent loss of capital (in real terms), then equities are also less risky.

Most people think exactly the opposite. People mostly associate risk with volatility, whether knowingly or unknowingly. So for them, equities appear to be risky and holding cash appears to be safe. Holding cash, however, brings the certainty of a permanent real loss of capital. We want to steer clear of this problem, and so we create a portfolio the great majority of which is composed of equities.

Three portfolio levels

We segment our portfolio internally into three levels.

The conservative core (robustness). There exists only a small group of companies in the entire world which are wholly unique and practically cannot be replicated. All of these have some permanent, sustainable competitive advantage, and their businesses are so robust that they can thrive under almost any conditions. There are not many of these, and when there is a possibility to buy stock in one at a good price, that is cause for celebration. We own stock in four such companies comprising one-fifth of the entire portfolio. Their attractiveness derives mainly from their combination of expected returns and very, very low risk. We would sell the shares in these companies only under the most extreme conditions, such as if their prices were to rise so much as to become outrageously expensive. Another case might occur if a dramatic slump were to hit the entire equity market. In such instance, the share prices for our conservative core companies would probably decline by much smaller increments and thereby become a very rich source of cash from which to acquire other, momentarily much more attractive investments.

The value majority (usefulness). The majority of our portfolio is composed of shares in very high--quality, financially strong companies. The value of these companies grows solidly over time, and they are managed for the benefit of shareholders. By their quality these companies do not attain the uniqueness of those companies in the conservative core (of which there are truly only a few), but they generally stand just a bit below them. Their somewhat higher risk is balanced by their appreciably higher expected returns. The majority of the returns to our portfolio are generated by these very companies. We measure the anticipated holding period for these shares in years.

The opportunistic. From time to time, there appear in the market attractive investment opportunities in companies which, for reasons of their type and character, we would not want to hold over the long term. It would be a real waste, however, to ignore these opportunities, and so the smallest part of the portfolio is made up of just these cases. Sometimes there are more of these, sometimes scarcely any at all. It is not possible to plan this in advance, as it depends upon these opportunities arising and, above all, upon how successful we are in finding them. These positions have the greatest turnover, and indeed some of them remain in our portfolio for only a couple of months. The return, however, can be excellent.

Are you still missing the beauty in our portfolio of which Vitruvius wrote? We think it is there. We do not see beauty in a great multitude of transactions or in titles which soar, are sexy or represent some sort of fashionable social change. We see beauty in simplicity. In architecture, in music and in investing, the most beautiful things are ingeniously simple. We strive to achieve that beauty in our portfolio.

Changes in the portfolio

We sold three positions. Each has a story connected with it. Here they are:

General Motors is not really a company we would like to hold over the long term. Automobile manufacturers have many characteristics which we view negatively. This is a very capital-intensive business, which often means carrying large debts. The sector has chronic overcapacity globally, and it is very cyclical. So why, then, did we hold GM shares? GM once was a company which was good to sell short at any price. That was our opinion about it before the great crisis, and we were not alone in that. Mainly, this was due to its colossal indebtedness. GM went through bankruptcy during the crisis, following which, at the close of 2010, it returned to the market as a company of uncustomary financial strength and with the U.S. government as its majority owner. Whereas before the bankruptcy GM's balance sheet had been its acute weakness, on the other side of bankruptcy it had almost become its pride and joy.

The market did not take proper note of this, however, and in connection with the expected large sale of the government's shares, it valued the shares unreasonably low. We therefore had put aside our distaste for automobile manufacturers and in 2012 had acquired GM. We have now sold it with a 70% gain.

Tesco is a stock we bought (most of the position) at the start of 2012 on the day when its shares recorded their largest one-day drop of all time. We were pleased to discover shortly afterwards that Warren Buffet had purchased a 3% stake in Tesco on the very same day. Our investment proposition was as follows: The British market was dominated by four strong companies, the biggest of which was Tesco with a 30% market share. The preceding decade had been marked by sweeping growth in retail sales footage. The British market, however, was already more than saturated, and smaller investments would be required in future to support greater free cash flow. Tesco's new management, which had taken over in 2011, is not so tied into the history of expanding abroad, and we had expected that it would sell off some of its loss-making foreign businesses. Both of these expectations were fulfilled. Tesco began to slow its domestic expansion and free cash flow was able to grow. Tesco further sold off its American and Chinese businesses, both of which had been in losses for a long time. It would seem that everything is well on track.

Something happened that we had not expected, however. The long-standing tranquillity on Tesco's home market began to be disrupted by aggressive expansion on the part of the Lidl and Aldi chains. It gradually become clear that this could bring such pressure on margins that the big four would have no choice but to compete through lower prices. We believe it is already happening and that this situation will bring Tesco lower profits over the long term than we had originally expected. We therefore sold Tesco. Our gain was 9%. Although our original assumptions turned out to be incorrect, we nevertheless realised a favourable gain. This is especially due to the fact that we bought the shares at a truly low price. This created a large margin of safety and a price reserve to cover for even a mistake or future negative development.

A large margin of safety is a fundamental element in our risk management.

Preferred shares in Fannie Mae and Freddie Mac. Fannie and Freddie are among the symbols of the financial crisis and the excesses of those times. They are private companies whose obligations are guaranteed by the state. This combination entails a great moral hazard. The task of Fannie and Freddie was to support the housing construction market, in particular by guaranteeing mortgages. In 2008, the companies were under threat of bankruptcy, and they were taken over by the state.

This all occurred in an unusual manner, however, whereby the companies' legal structure remained intact. Fannie and Freddie had in circulation several issues of preferred shares which were not in any way affected by the takeover, with one exception: dividend payments ceased. As a result, the preferred shares were trading at one-tenth of their nominal value. From a long-term viewpoint, this presented a binomial distribution of possible outcomes. Either zero or one, as it were, and no possibilities in between. If Fannie and Freddie were to be liquidated, the preferred shares would be worth nothing and we would lose our entire investment. If Fannie and Freddie were to survive and wish to return to the market, however, then they would need to restart paying dividends to holders of their preferred shares and we would have grown our investment 10-fold. The return profile of the two alternatives was thus 10:1.

In view of the probable outcomes, this appeared to us an attractive combination, and we bought preferred shares in both Fannie and Freddie. Fully understanding the large speculative element, our initial position was small. For a while nothing happened, but when it gradually began to be clear what great profits Fannie and Freddie were achieving and how their role on the mortgage market was continuing to grow, then the probability also began to rise that neither company would be pushed by the state into liquidation. In response to this, the preferred shares saw tremendous price growth. We recently sold them with gains of 376% (Fannie) and 300% (Freddie). Their return profile had fallen from 10:1 and was approaching 1:1, and that was too risky for us.

We bought two new positions.
The first is in Russia.
What? Have we gone mad? Well, not completely.

Russia is not a foreign market for us. I myself made my first investment there in 1996, and the title that we just bought I had myself owned back in 1997. Since that time, I have followed the stock from a distance. Over the past two years, we have looked at it in detail several times. We always came to the same conclusion: although the price is very low we do not want to buy the stock because it is in Russia. At the same time, we were asking ourselves if we were not making a mistake. The Russian market is very unpopular among investors, and that is exactly why share prices are so low there.

When Russia invaded Ukraine, investors' distaste for Russia and the low prices of Russia shares shifted even one level further. A typical portfolio manager at a big bank or investment or pension fund considers it thusly: If I have Russian shares in my portfolio, that doesn't look very good. My superiors, risk managers and investors will ask me about them. Given the risk to my career, it would probably be better to sell them. Then no one will bother me about them, and people will leave me in peace.

If the majority of investors considered things in this way, then the market would be flooded with orders to sell Russian shares. And that is just what happened. So we bought a few. We kept our wits about us, though, and so this investment is very small. We think that the returns will be very nice.

The second position is in America. For most of the Fund's life, we have held a smaller or larger portion of the portfolio in bank deposits. These earn us nothing, so we have been searching for (and found) a different form through which to place a part of this money. Real returns (above inflation) should be 4%, which represents a good alternative for temporarily parking cash.

I wish you a nice spring, and I look forward to seeing you at the annual Shareholders Meeting.

Daniel Gladiš, April 2014
