VLTAVA FUND

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

VLTAVA FUND

ON the BEAUTY OF UNCERTAINTY

Dear shareholders,

In the first quarter of 2012, the fund's NAV grew by 6.8%.

Please permit me to begin this letter with a slight digression…

In 1980, John Lennon put out an album entitled Double Fantasy. It was the last record released during his lifetime. The album includes the delightful composition "Beautiful Boy", a lullaby for his son who was six years old at the time. The lyrics contain an inconspicuous but aptly philosophical line: "Life is what happens to you while you're busy making other plans". The sad irony is that just a few weeks later Lennon was dead, and, judging from the extensive interview he gave on the day of his death, Lennon really was full of plans for the future.

Investing is similar in the sense that its results depend upon future developments. Stated more precisely, those results depend upon future developments in combination with the composition of the portfolio. While we have no control over the future, we have 100% influence over the composition of our portfolio. In a perfect world, we would have the ability to predict how the future will develop – and especially in matters affecting investment outcomes – and then we would compose the portfolio accordingly.

We openly admit that we do not possess such ability, nor do we know of anyone who does possess it. So, we have to create our portfolio such that it fares well in the majority of possible future scenarios. As of the end of 2011, most investors thought that January would bring a considerable market slump and that the events in the euro zone, and especially concerning Greece, would continue sharply to escalate. For this reason, many investors held much more cash than usual, and short positions in the euro were reaching historic records.

The start of the year surprised most everybody

The situation in the euro zone has now calmed to a certain degree (although only time will tell for how long). The equity markets have risen significantly, and so has the euro. Our portfolio fared relatively well. For reasons that can be neither proven nor disproven and about which we can only speculate, history chose this course. We need to remember, however, that it could have gone down a very different path – indeed, any one of many other paths.

This gives rise to the following questions: Would we have composed our portfolio differently had we known developments would take the course they did? Or, if we had known, on the other hand, that developments would have been significantly worse than they in fact turned out to be?

Probably not.

If we exclude extreme situations, which do occur sometimes but are hard to predict (in fact, difficult even to imagine), our portfolio would be the same, regardless of what development we anticipate. **Because we recognise that our ability to predict the future is marginal at best, it would be a grave mistake to make investments the success of which depends on one specific development scenario.** It is better to try and make investments the success of which will not be significantly affected by most possible and reasonably probable scenarios of development.

When we speak of success, we refer here to what happens to the value of the companies in our portfolio, rather than to short-term movements in their share prices. Sometimes, we retrospectively test the correctness of our approach by considering possible alternative courses of historical development and endeavour to estimate what their impacts on our portfolio's value would have been. For example, how would our portfolio's value have been affected if Greece had declared bankruptcy last year and left the euro zone, if one or more large banks had collapsed, if the price of oil had plummeted or skyrocketed? If we conclude that the influence of these and other, similar alternative development scenarios and shocks would have had but little influence on the value of our companies, then this suggests that we are picking our investments properly.

VLTAVA FUND

Changes in the portfolio

We sold three positions in the quarter: Heineken, PepsiCo and Cielo.

Heineken we had purchased in early 2009 at prices around EUR 21. This year, it climbed to EUR 40 and we considered it more than fully valued. There was no margin of safety between the price and the value of the share any more. Indeed, the price had even exceeded the value. It was time to realise a profit and to sell Heineken.

Our position in **PepsiCo** had been a little disappointing to us. We had been expecting a better outcome. Finally, we sold the shares after holding them for nearly two years for the same price at which we had bought them. PepsiCo has been treading water for some time, growing only slowly, and there are better investment opportunities on the market.

The Brazilian **Cielo** was our first and to date only investment in Latin America. Cielo is one of two dominant companies in Brazil in the business of settling payment card transactions. This is a very profitable duopoly. We had expected to hold it for a long time, but the price of the shares started substantially to rise immediately after we bought them. After holding them for 9 months, we sold the shares with a 50% gain because, as true of Heineken, they were no longer sufficiently undervalued for us.

We have one new position. Here's a clue:
It is an American company, well-known and very large. We have been monitoring it for 15 years, and I always wanted to have it in the portfolio. Nevertheless, its price was too high through that entire time despite its high quality. This has recently changed. Once again, high quality is available in the market for an unreasonably low price. There was no reason to hesitate. Moreover, the purchase of this share has another bonus for us. The legendary and genial businessman who manages it is now working for us. Have you already guessed which company this is? We will reward correct guesses at the shareholders' meeting with a bottle of wine!

In addition, we were continuously taking advantage of the market volatility and we added to our positions in five other companies.

World full of uncertainty – a normal state

Many people think today's world is full of uncertainty. That, however, is the way it has to be by definition, and the world cannot be any different. It is hard to say whether there are more uncertainties today than usual. People usually tend to overrate the importance and scale of recent events in comparison to those occurring earlier. If we look back into history, however, we can find any number of periods that were much more turbulent, both politically as well as economically. The current period appears scarcely dramatic at all alongside the likes of such years as 2008, 2000, 1997, 1991, 1987, 1980, 1978, 1968, 1962, 1939, 1929…

In looking at these years, we may not even realise what was going on at the time, even though it always was a serious crisis with global impacts. In any case, the one certainty in this world is that it will continue to be full of uncertainty. That may be a banality, but it has crucial consequences for investing. It leads us to the following conclusions:

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1. **The greatest mistake would be not to invest at all.** If the future is uncertain, that only heightens the need for people to prepare for it financially.

2. **The best long-term investment is in stocks.** Given the valuations today of stocks and other investment asset classes, and given the world's probable development, this scarcely can be doubted.

3. **Over the long term, stocks carry lower risk than do bonds and cash.** Inflation is the investor's greatest enemy (and one of the greatest uncertainties). In the long term, stocks are best able to cope with that uncertainty.

4. **Among stocks, we tend to focus on quality.** Considering the many and varied future development scenarios, they fare the best.

Our portfolio is today composed mostly of shares in high-quality companies that are financially strong, with solid positions in their markets, and with safe and growing dividends. This was not always the case, but the progressive acquiring of experience, advancing age, learning from our own errors and, ultimately, the valuations of the individual shares themselves all lead us down this path.

Daniel Gladiš, April 2012

P.S.: A hockey fan's postscript

If we were always certain at the start of the season that Kometa Brno would reach the championship finals, then hockey would hold no interest for us. The uncertainty is truly the most attractive part of it. Uncertainty is beautiful.

VLTAVA FUND

IS A BREAK POINT CLOSE AT HAND?

Dear shareholders,

In the second quarter of 2012, the fund's NAV fell by 11.39%.

The last week of April and month of May marked the worst period for our fund since 2008. Prices for the majority of our shares fell sharply, albeit in no way relating to a change in their underlying values. At the end of May, our portfolio had its most attractive valuation in the fund's entire history. The combination of quality, low cost and overall market risk was then more favourable even than at the beginning of 2009.

The majority of our companies are currently achieving historic, record-breaking profits and have record dividends. On the other hand, their prices are mostly deeply below their highs. Even despite the fund's high returns in June, our portfolio remains priced at a very low level and it is therefore also relatively safe.

Why do we invest at all?

At the April meeting of the fund's shareholders, we started our presentation with just this question. Sometimes it doesn't hurt to return to first principles as they relate to one's rationale and actions.

Every person who has money exceeding that required for his or her present consumption faces this fundamental question: To invest or not to invest? As long as one does not invest and allows money to lie idle, with each passing day its value becomes less and less. That is due to inflation, and even our current moderate annual inflation rate of around 3.5% will erase 19% from money's value in 5 years' time. After 10 years, this decline would come to fully 41%.

It would be irrational to devote one's energies to earning money and then allow it to lay idle and watch as it gradually sheds value. It is certainly better to make an effort so that the value of money will be at least preserved, or even to grow. In other words – to invest. If inflation were zero, or even negative, we would not need to invest. The value of money would not decrease and in future it would be possible to purchase using it the same amount of goods and services – or even more – as today. Unfortunately, however, inflation is persistently positive. Thus **inflation is both the investor's greatest enemy and, at the same, greatest incentive!**

Our investment philosophy

While investing can be conducted in a million ways, it is possible to summarise our investment philosophy in five points:

1. **Stocks make the best long-term investment.**
   The approximate real returns on individual asset categories over the course of the past 200 years are as follow: the dollar lost 95% of its value, while gold increased in value by 6 times, bonds by 1,000 times and stocks by 600,000 times. These figures refer to the American market, because it offers the longest and highest-quality data set. Nevertheless, it holds true generally that in the long term it is worst to hold cash and best to hold stocks

2. **The basis of investing into stocks is regular cash flow in the direction from companies to their shareholders in the forms of dividends and repurchase of their own shares.**
   This relationship is often forgotten. More often than not, people do not realise that buying stocks is first and foremost acquiring a share in an enterprise's business. They often view stocks merely as an abstract object of speculation. At the same time, the reason why we buy them is no different than for why we buy bonds (to receive coupon payments), real estate (to obtain rent) or we use bank deposits (to collect interest income). Particular investments are valued according to their individual cash flow streams. Real estate that during its lifetime never brings in a single cent of rent has zero value, and the same is true for a company that during its lifetime pays no dividends. This is true by definition. Conversely, the higher the associated cash flows the more valuable is the given investment.

3. **At good companies run by quality managements, cash flows have a strong tendency to grow.**
   This fact can be confirmed through numerous examples. At the same time, it is abundantly clear that not every company falls into this category. At many companies, cash flow either fluctuates excessively,

decreases, or even vanishes for good. And that's where lies half of our work, as we look for companies whose cash flows grow in the long term and whose management works in the interests of shareholders.

4. **In the long term, share prices follow growth in cash flows.**
   This is a verifiable rule (although by no means a natural law), which has the tendency to reinforce itself over the long term. The second half of our work thus lies in endeavouring to forecast what value should be placed on the expected future cash flows of selected companies and then in buying those shares which trade at prices significantly lower than their estimated values.

5. **Many people think of the stock market as a casino and stocks as poker chips, thanks to which we can often buy shares at prices significantly lower than their intrinsic values.**
   Theoretically speaking, in an efficient market, the prices of shares would always reflect (at least approximately) their actual values. **People, however, are not flawless machines without emotions.** They make mistakes in their judgments and, moreover, they become overwhelmed by fear interspersed with greed. That's lucky for us. Were it not that way, it would be far more difficult for us to seek out good investment opportunities. But people are people, and so they will always remain. For that reason, the market will continue to be inefficient and will carry on in generating extraordinary investment opportunities. If we will succeed in taming our emotions and if we will maintain our investment discipline, we can profit greatly.

Short side of the portfolio

The foundation of our strategy is comprised of the portfolio's long side and a relatively concentrated set of shares chosen according to the aforementioned principles. In addition, we have in the fund a much smaller short side. In it we have:

1. A broad market index or indices serving for hedging purposes, and, as the case may be, as a low-cost source of capital.
2. Positions in individual companies whose shares are substantially overpriced and in relation to which we anticipate earning returns from their future decline in price.
3. On top of that, we use selective options either as sources of cash flow or as tools to increase economic exposure to individual companies while excluding possible losses.

The short side of the portfolio and options are complements to our long side, and they bring to the fund additional value and yield.

As I now read what I have just written, I am aware that our investment philosophy is in principle very simple. I candidly admit that it was not always so simple. When we started eight years ago, we looked at investment similarly as we do today, but we often complicated things unnecessarily. We were younger and more ambitious and we sometimes had the tendency to look for additional value in the twisting and turning tributaries of value. Time has taught us that is exactly where the greatest mistakes are made and that it is better to keep a steady course in the main channel of our investment philosophy. Today, it seems to us that the simpler the view we take of things, the better. I am curious myself as to how our investing will develop in the years to come. The beauty of investment is that experiences do not cease to accumulate, and one can constantly improve. At the same time, it holds true that one does well not to skip over or shorten the knowledge accumulation stage.

„Investing is simple, but not easy.“
Warren Buffett

Changes in our portfolio

We were very active in the last quarter. Large share price movements in April and May brought many opportunities and we strove to exploit these to the maximum extent.

We sold three positions: Axis Capital, Lockheed Martin and General Dynamics.

In the case of all three companies, the main reason for selling was the fact that we had other, more attractive opportunities open to us. In the cases of Lockheed and General Dynamics, a second reason factors in, and that is that the main customer of both companies is the United States government. It is possible that the U.S. federal budget may descend into chaos at the turn of the year, and we do not want to be affected by that. We would rather sell both shares in advance. Our overall holding period gains from owning these shares come to 57% for Axis, 30% for Lockheed and 4% for General Dynamics.

We have three new positions in the portfolio, all of them in the United States. In addition, we bought more shares in an additional five titles that we already had in the portfolio.

Among the short positions, we closed that in Lululemon Athletica with a gain of 21%. Lulelemon's share price dropped sharply and the company shifted from the category (as measured in sophistication terms) "very expensive" to that of just "expensive". Its potential for decline that springs in part from overpricing had partially run its course, and therefore we exited that short position.

In what phase do we find the market today?

Market development is largely cyclical. The stock market runs in cycles, the individual phases of which are:

Euphoria – Anxiety – Pessimism – Apathy – Deliberation – Optimism – Euphoria

And then it starts all over again. The duration of the cycle may vary greatly. If we take a period of euphoria as the start of the cycle, then the present cycle is in its fifth year. The previous cycle lasted for 7 years (2000–2007), and the one before that 20 years.

It is good to know approximately where we find ourselves within the current cycle, because history shows us quite plainly that the best investments are made in periods of apathy, which means at just such time as the majority of people dismiss investment as entirely inopportune. Stocks are not much in demand during periods of apathy and are therefore low priced. That is in accordance with our motto that **only truly unpopular assets can be really cheap.**

So are we in a period of apathy today? I believe so, and for three reasons:

1. Through the 20 years of my investment practice, I have experienced no less than seven global market crises, and **I do not recall people's views towards stocks ever being so negative as they are today.**

2. In the past two years we generally have seen record outflows of money from stock funds and record inflows of money to bond funds. This is a classic phenomenon accompanying periods of apathy. **The majority of people do just exactly the opposite of what they should do, as time later reveals.**

3. On the government bonds market we have witnessed a gigantic bubble, which is most likely near its climax. **The overpricing of bonds, as the polar opposite of stocks, is consistent with the notion of a present period of apathy towards stocks.**

I am convinced that in future we will live in a world of much higher interest rates than today. This will wholly decimate bond portfolios, and it will greatly disappoint bondholders. Evidently, few people realise how quickly, for example, a 10-year bond can lose a quarter of its value. One need only take a look to the south of us.

At the beginning of June, the yields from bonds in countries like the United States, Great Britain, Germany or the Netherlands were at historic (or at least several-hundred-year) minimums. Their real values were mostly negative. Masses of investors unthinkingly are moving huge sums of money into them, which situation represents for me an incomprehensible misconception as to the security of these investments. So long as we lean on our argument from the outset that an investor's main enemy and also incentive is inflation, then bonds represent today an extraordinarily risky investment that carries negative real value.

The final resolution of the present debt crisis in the majority of countries must contain elements of financial repression. One of the main such elements will be inflation, and holders of government bonds will be the main victims. Negative real rates of return on deposits and government bonds ultimately show that this repression already has begun.

When interest rates begin to rise – and it is only a matter of time before that will be the case – then bonds will start to stagger and investors (who will lose money on bonds thereafter) will commence, in droves, to shift their money elsewhere. A great deal of it will go into stocks. That will mark a major inflection point in the market's development and a change in investor behaviour and thinking. When this break point will occur, no one knows. It could have come last month; it could arrive next year, perhaps even later. It may, however, occur abruptly and unexpectedly. Therefore, it is better not to try to forecast it precisely but rather to prepare one's investments for the change in advance.

Now, we are aware that to have a view too much in advance is, in essence, indistinguishable from having an incorrect view. **But, it also is much better to be somewhere a little bit early than entirely too late.**

In closing, a paradox: the majority of investors today are extraordinarily apathetic towards stocks. At the same time, after last year we are recording the greatest interest from new investors into our fund. In order for an investor to be successful, he or she must often do just the opposite of what the majority does. Our views are perhaps in the minority, but they certainly are not unique.

I wish you a pleasant summer.

Daniel Gladiš, July 2012

QE 4EVER

Dear shareholders,

In the third quarter of 2012, the fund's NAV grew by 5.2%.

In slight contrast with the trend of recent years, markets were unusually calm this summer. This was not such a bad thing. At least we could better enjoy the holiday season's two highlights: the Olympic Games and Bruce Springsteen's concert in Prague. I saw Bruce for about the seventh time, each seemingly better than the last. In Prague, he played for over 3 hours without a break, even though the organisers turned up all the lights at the stadium an hour before the end to indicate that time was up. A few days later, during a concert in Hyde Park, the police even turned off the microphones. In the land that gave the world the Beatles! This did not unsettle Bruce, however, and just after that he played for over 4 hours in Helsinki. It's a shame that people like Bruce are not candidates in presidential elections…

Central banks back on the offensive

Unfortunately, slightly different sorts of people are found in politics, and just after they returned from their vacations they clearly indicated that they intend to continue to interfere with the course of history. The European Central Bank (ECB) was the first to make itself heard. It declared that the euro is irrevocable and that it will do "whatever will be necessary" to maintain it. Such proclamations can send shivers down one's spine.

The ECB also announced that it will purchase the bonds of euro zone states that are under pressure, should they themselves request international assistance. Such aid is conditioned upon strict demands with which the applicant country must comply. Of course, no one wants to do this voluntarily. Spain, for example, to which this applies first and foremost, will almost certainly request help. It will probably wait until the last possible moment, when the situation becomes entirely untenable. It will then ask for assistance, receive a list of conditions, and, if it undertakes to fulfil them, ECB will buy its bonds.

An interesting situation may occur sometime later, when ECB has its books full of Spanish bonds and the country ceases to fulfil the conditions of aid. What will ECB do then? Will it stop buying Spanish bonds? The local market would collapse. Or will it keep buying them and disavow its own declared conditions for the purchases?

Moreover, ECB undertook to "sterilise" the purchases of Spanish bonds in order to appease Germany. In practice, this means that it will sell other bonds – most likely German – in the same amount in order not actually to print new money. ECB's bond portfolio would thus shift from the highest-quality German bonds to the most problematic Spanish ones. I dare say, they will be the only ones in the world to be making such a reallocation.

An even more aggressive Fed

The U.S. Federal Reserve got into the act a week after the ECB. It announced another wave of quantitative easing (or "QE3", a euphemism for once again printing money) for an indefinite time (yet another proclamation to give one the chills). It essentially initiated interminable QE – QE 4EVER.

The Fed's step caught many by surprise. The U.S. economy will grow by almost 2% this year, and in the following 2 years (according to the Fed's own estimates) by around 3%. Interest rates are at record low levels, and that includes mortgage rates. The housing market is slowly recovering, and the stock markets are not far from their all-time highs. Based on this data, the exigency for another wave of QE somehow escapes me. It is true that unemployment is holding stubbornly above 8%, but that will not be diminished by printing money.

The main problem lies elsewhere: in the state's large role in the economy, in excessive regulation of business and the labour market, and in the uncertainty that politicians create through their actions. In response, companies invest meagrely and consumers spend little. But try telling something like that, for example, to President of the European Commission José Manuel Barroso. His calls for a European federation, a common army and, above all, federative taxes sound as if they are coming from another world.

In 1985, Bruce had a huge hit "Born in the U.S.A." Who will come out with the hit "Born in the E.U."?

Changes in our portfolio

We sold 4 titles during Q3.

Seagate Technology. Seagate produces hard drives. This industry recently underwent an interesting development. Originally, there were 5 companies dividing the market amongst themselves. They frequently tried to compete on prices, which, as a result, damaged all of them in the end. The two largest, Seagate and Western Digital, then bought two of their competitors and suddenly controlled 90% of the market, thus gaining greater control over prices. Then came floods in Thailand, substantially disrupting the supply of hard drives to the market and considerably driving up prices. Seagate's profitability markedly increased, but its share price did not reflect this. We bought Seagate during the spring slump in stock markets and sold the shares after about 2 months with a gain of 56%. We were aware of the cyclicality of this industry, as well as of the fact that, in this case, estimating share values is rather difficult. We were happy to take a profit.

Johnson & Johnson. We knew we were buying high quality when we bought shares of JNJ. Our expectations regarding future development, however, were not fulfilled. The company was treading water, was searching for a new direction, and, moreover, we were not satisfied with the way JNJ allocates its capital. We therefore sold the shares with a total gain of 13%.

BP. We considered long and hard to buy BP shares back in 2010, when major news media were carrying images of oil gushing into the bottom of the sea from BP's Macondo well. Such screaming negative publicity often slashes share prices to unrealistically low levels. BP's stock was no exception. Nevertheless, it seemed to us that the risks were too great and that it would be better not to buy. We did so a year later, however, at an only slightly higher price and with much lower risks. We held them for a year, but negative impressions gradually started to prevail. BP's business itself lagged behind expectations, damage compensation claims for Macondo are still unresolved, and great disputes with the second shareholder in their Russian JV continue. So we decided to close that chapter and sold the shares with a total gain of 10%.

Halfords. We were not playing a lucky hand with the British Halfords. Our conclusion regarding the quality of the company and its outlook had probably been incorrect. We might just as well acknowledge our mistake. We sold the shares at a loss of 29%. Fortunately, it was one of our smallest positions, and so the damage is minimal. Incidentally, Halfords is the only stock bought in the last 2 years that is in loss territory.

On the short side of the portfolio, we closed our position in Chipotle Mexican Grill with a gain of 24%.

We also acquired two new positions. The bosses of the two companies are legends, are absolute aces in their fields. Their businesses have low correlations with the business cycle, and we expect double-digit annual returns from both titles. Investors spend half of their time debating whether Apple shares will reach a market cap of a trillion dollars while allowing a number of high-quality and much more attractive shares to go unnoticed.

Macro vs. Micro

There is nothing rosy about the world's macroeconomic outlook. We can look forward to an extended period of slower growth, never-ending struggle with debt, occasional periods of escalation in the case of Greece's leaving the euro zone, the American fiscal cliff, and more.

One should recognise, however, that stock market growth is neither conditioned upon, nor correlated with, rapid economic growth. For example, the U.S. stock market remained unchanged between 1964 and 1981. During that period, GDP grew by 373%. In contrast, between 1981 and 1998, the American stock market increased tenfold and GDP only grew by 177%. The Chinese economy is one of world's fastest growing economies today, while the Chinese stock market has been among those declining most in the last 3 years.

We are not macro investors, and we do not try to invest according to estimates of macroeconomic development. Nevertheless, we of course are not blind to those developments. The conclusions we draw from them rather concern the long-term impact on individual asset classes. We believe that **if a state puts its mind to devaluing its currency** (reflect upon the Fed's recent action), **it will usually succeed**. This means that long-term bonds (which we refer to as "certificates of confiscation") can be held only by investors with an especially developed sense for financial masochism. Their extremely low yields fall far short of offsetting the associated risks for their prices to decrease. Shorter-term bonds yield so little that a number of money market funds are getting out of that business altogether. Cash yields nothing. All manner of debt instruments and deposits yield negative real returns and bear great risk of substantial real losses. And I haven't even mentioned the fact that states have every motivation to falsify downward their data on inflation. Real inflation may in fact be markedly higher than that officially stated.

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The impact on share prices of printing money should be neutral in real terms and nominally positive over the long term. We therefore think that a considerable portion of savings should be invested into stocks.

We consider ourselves to be micro investors. This means that we are not buying stock markets as a whole, but, rather, seek individual companies that will do well under almost any conditions and whose shares are, at the same time, low-priced. There are not many of those, but they can be found. We are approaching the end of the year with a part of the portfolio in cash, and the next time the market stumbles it will surely bring us attractive opportunities. With a certain measure of cynical materialism, we are looking forward to it!

Daniel Gladiš, October 2012

VLTAVA FUND

TWO – ONE – ZERO.

Dear shareholders,

In the fourth quarter of 2012, the fund's NAV increased by 1.8% quarter on quarter, and thus by 1.3% for the year as a whole.

Perhaps you are wondering why our result was not better given that the past year was actually quite favourable for equities. Last year we made an investment error which cost us approximately 8% in yield. A detailed description follows.

Our investment error last year

In the past six years we spent a lot of time and effort searching for attractive investments in the metal extraction sector, focusing mainly on companies extracting copper and nickel. We analysed 113 of the most important projects under construction or in planning. We mapped their capital spending, operating expenses and anticipated production. From this data we then estimated how much copper and nickel would have to cost over the long term for these projects to be at all sensible, to bear reasonable returns, and sufficiently to satisfy market demand. Armed with this "incentive price", we were looking for the most attractive extraction companies and investments.

Our investment results were mixed. Some were good, others disappointing. The more we came to know this industry, the more we inclined toward the opinion that in general it is not a favourable one from an investment perspective, is too risky, and that it is better to avoid it entirely. We gradually terminated our investments in extractors and by early 2012 only one remained – the Canadian Baja Mining. We believed (in retrospect, mistakenly) that it was a promising exception. We were not alone in this belief. Baja Mining owns the El Boleo project, which constitutes a large deposit of copper, cobalt, zinc and manganese in Mexico. Thirty per cent of the project is owned by a Korean consortium with state participation and the rest is co-financed by US and Canadian state institutions. We visited the company's management at its headquarters in Vancouver, and we were in contact with them at least 20 times during the period when we held the shares. It was not enough.

As project construction neared its culmination last year after many years of preparations, it transpired that the construction would cost about 20% more than budgeted. Baja Mining was not able to raise the money quickly and had to transfer most of the project to the Korean consortium. The Baja Mining shares responded with an immediate and sizeable price drop. This all happened at the turn of April and May.

In looking at the development of the fund's NAV during 2012, you can see that we had two bad months – April and May. This is largely due to Baja Mining. The El Boleo project is continuing and will very probably be completed, but Baja Mining's shareholders have lost the majority of their investment.

The entire matter greatly disappoints us, because it distorts an otherwise agreeable year and a number of good investments and transactions we made are therefore not evident.

The return on the fund's portfolio for the 7–month period from the collapse of Baja Mining up to the end of 2012 had been 16.1%. Unfortunately, this good result from the remaining and new investments disappears when one views the year as a whole.

We made two mistakes in 2011 and one last year. We believe that we will confirm this trend this year: two – one – zero.

Changes in our portfolio

In addition to the remaining Baja Mining shares, we sold one other position.

Apple. Yes, we owned stock in Apple. For the whole of 18 days. Apple shares underwent a large price correction and at one point we had the impression that a number of investors were selling their shares even against their will. We wanted to benefit from that. We bought a medium-sized position in Apple shares and soon sold it with a gain of 9%. This is not a typical trade for us, and for two reasons. First, our opinion of Apple is rather negative and its future seems to us entirely unpredictable. Second, we do not favour such short-term investments. We mostly buy assets with the perspective of holding them for years rather than days or weeks. Nevertheless, we are not blind to market developments and when it seems that the scales are markedly tipped in our favour, why not take advantage? In any case, this will constitute a rare exception; we have no intention to reorient ourselves in such direction.

On the short side, we closed a position in Athenahealth with a 31% gain.

We added four long positions. The US market responded negatively to Obama's re-election, and its correction brought with it several attractive opportunities. Three companies are new to us. They are from the technology, finance and retail sectors. The fourth company we have already held in the past, and we do so now for the second time. In all cases, we expect double-digit annual yields from the holding period.

What will the future bring?

We do not know, of course, but we are aware of certain circumstances that may influence it. We are living at a time when interest rates are at their lowest point in history. These are helping over-indebted states to better carry this burden, and in some cases even to survive. **It is possible that the period of low rates will continue for some time still to come, but it clearly represents the greatest risk for investors in the outlook.**

Valuations of all (not just financial) assets are determined by interest rates. As soon as these begin to rise, there will be great pressure for asset values to depreciate. This pressure will not affect all assets in the same way. Assets with fixed yields (such as bonds) may be decimated, as will assets with no yield (such as gold). Individual equities will be affected differently, as these are assets with variable yields. Companies owning real assets will fare the best, because their cash flows tend to grow in periods of long-term increased inflation. Companies with low indebtedness and those whose profits will markedly increase due to higher interest rates will also fare well. Most companies in our portfolio have at least two of these three characteristics and thus provide some protection against the loss of value in real money terms through higher inflation.

Current 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 it does not correspond to the quality and prospects of these companies. This number especially stands out in comparison with interest rates that are almost zero. **By our estimate, the fundamental value of our shares today is about one-third higher than are their current prices.** The fundamental value is not static, however, but develops gradually. In the case of our portfolio, it has been growing rather solidly. At the end of this year, it will be on the order of 50% higher than today's prices. This should create sufficient upward pressure on the prices of our assets.

Our portfolio has fared much better than last year's overall result suggests. From the numerous conversations we have had with you, our shareholders, we feel that you know it as well. Last year's influx of investors and new money into our fund – the largest in the last four years – is further evidence of that.

We thank you for your patronage and wish you all the best in the new year.

Daniel Gladiš, January 2013