VLTAVA FUND

Dear Shareholders,

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

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

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

Table 1. Fund's performance since launch

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

The performance figures shown above look good, but we have to keep two things in mind. First, the last 3 years were actually unusually good for stock markets and almost any fool could make money. As they say: "A rising tide lifts all yachts." That also helped us. The future will not always be this bright. There will be poorer years, or even loss years. Second, we are still only in the third year of operations and that is still too short a time to jump to conclusions about how good we are. We said last year in our annual report that the quality of an asset manager only begins to show after at least 3–5 years. We are not there yet. Our results might still be reflecting more luck than skills. We have been repeating this like a mantra from the very beginning and it may by now sound like a broken record. But the truth is that we are dead serious. It cannot be repeated often enough. Moderate expectations are in order.

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

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

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

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

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

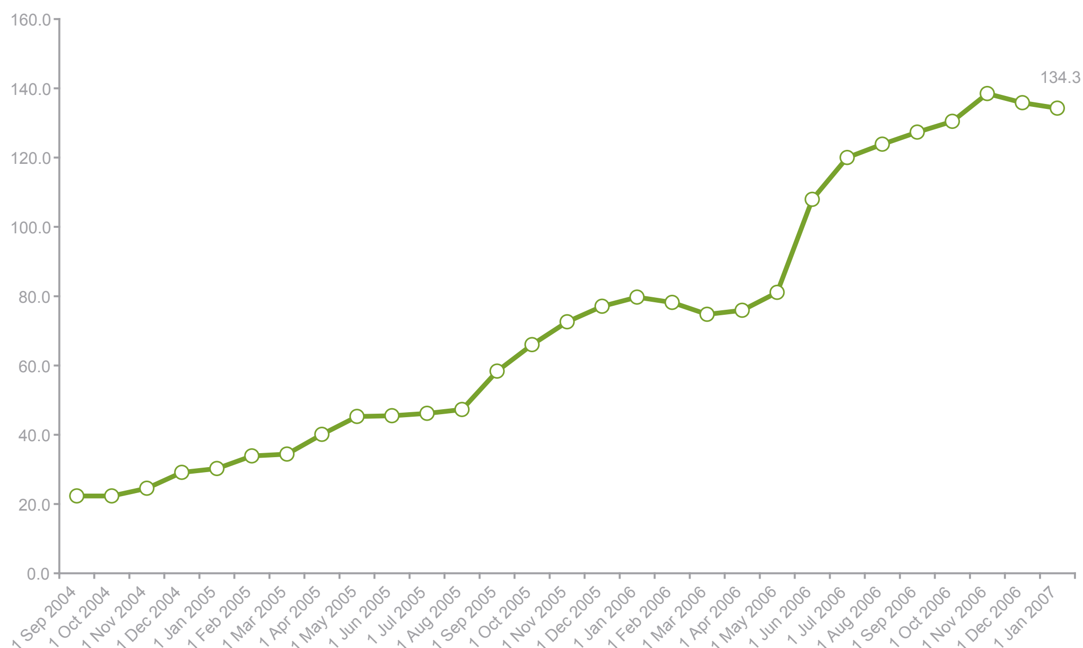
We normally have no idea whether the market is going to go up, down or sideways in the near future and, frankly, we do not much care. What we think we do know is how to recognize when a stock is substantially undervalued in the market. And that is what we concentrate on. We believe that if we buy at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

We use various measures and statistics internally, but perhaps the best one to consider here is that of so-called "look-through earnings", because it is simple concept that shows well the development over time. What are "look-through earnings"? This is a concept of looking through the stock ownership in a given company and down to the bottom line, then figuring out what is your share of that company's net profit. Here is an example. Suppose that we own 1% in a certain company and that the company has made annual profit of 100 million Then 1% of those 100 million in profits, or 1 million, is our look-through earnings. If the company makes 120 million of net profit next year and we still hold 1%, then our look-through earnings will be 1.2 million We can do that for each company in the Fund's portfolio and come up with the Fund's total look-through earnings. **Graph 1** shows how our look-through earnings have developed since the Fund's launch.

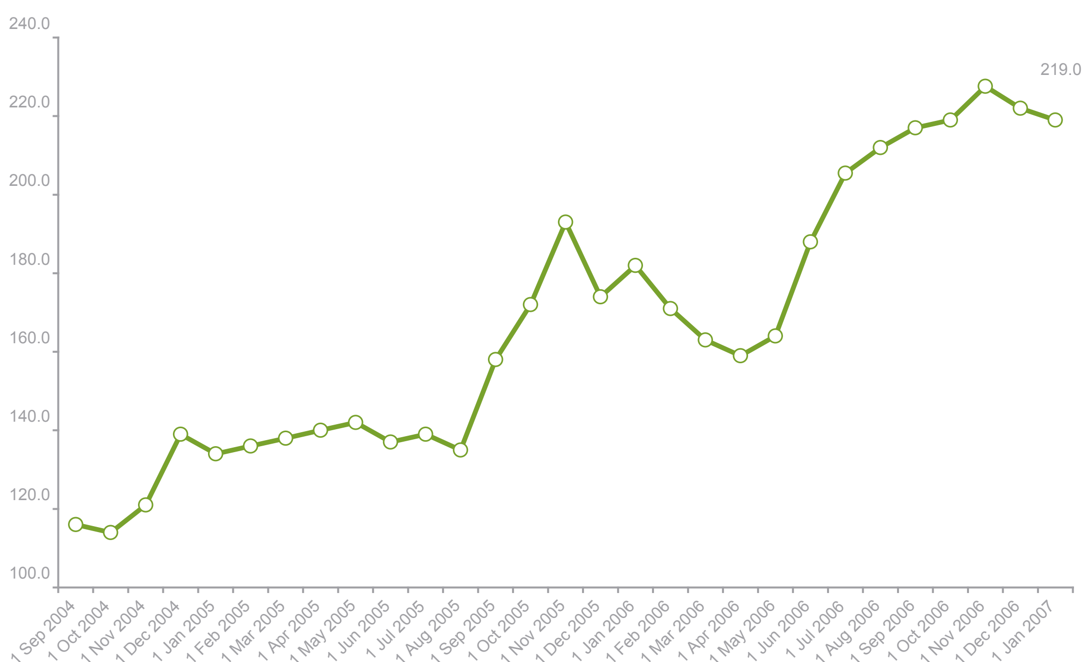
How do we calculate net look-through earnings? We take average earnings for the last 36 months for each of the companies that we hold and figure out what are our portions of those earnings. Then we do the same for our short positions and subtract the second total from the first. The result is net look-through earnings. Why do we use the last 36 months? It is because when we value a company and are looking at its earnings power, we always look at the average of the last 3 years. We do not take 1-year figures very seriously. They tend to be misleading.

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

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



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



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We get this figure by dividing net look-through earnings by the number of shares issued by the Fund. That figure shows whether the earnings of companies that we have in the Fund are actually rising. As you can see, net look-through earnings per share have grown from 116 to 219. That is, by 88%. That figure roughly corresponds with the rise in NAV of 67.6% We think this supports what we said above about picking good companies that grow their earnings. Indeed, if we put in the same graph the Fund's NAV evolution and its net look-through earnings per share, you will see how close they are to each other. See **Graph 3**.

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

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

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

Daniel Gladiš, February 2007

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

Graph 4: Net yield per share