VLTAVA FUND

INVESTING IN AN ENVIRONMENT OF DECLINING COMPANY EARNINGS

Dear shareholders,

In the second quarter of 2016, the Fund's NAV decreased by 8.9%.

The earnings cycle

Our long-term investment philosophy is based on acquiring company shares at prices much lower than their values. A company's value today is the present value of all future cash flows the shareholders may receive from today until Judgement Day. The more money a company makes the higher is its value. That is scarcely an earth-shattering revelation, of course. How individual companies' earnings develop markedly differ from one another, however, and the collective profitability of all companies on the market also follows an irregular course. Nevertheless, a certain cyclical pattern can be observed. Let's take a brief look at the phase of the earnings cycle we are in currently.

Let's begin with the US market. According to data from Standard and Poor's, the total reported earnings per share in the trailing 12 months for all those titles in the S&P 500 index combined peaked for the current cycle in the third quarter of 2014 at USD 105.96. The most recent earnings data, from the end of Q1 2016, put that number at USD 86.44. As is apparent, then, for more than a year and a half we have been living in an environment of declining company earnings and in that time profits have decreased by 18.4%. To put this into even better perspective, the two previous earnings cycles peaked in summer 2007 (at USD 84.92) and in September 2000 (at USD 53.7).

The earnings development for European companies is also cyclical, although the cyclicity has not been very apparent of late. According to data from Bloomberg, earnings per share of companies in the STOXX Europe 600 have been more or less unchanged for approximately 5 years, are lower than their high of 9 years ago, and are approximately at the level of 2005. European and US earnings had begun discernibly to diverge in 2010, after which time earnings in the US continued substantially to rise while those in European did not. Several factors may have contributed to this, including differences in the way the indices are structured, as well as poorer business conditions in Europe or a weaker focus there on creating shareholder value.

When companies' profits are generally and significantly growing, investing is easier and company value literally grows before one's eyes. In the declining phases of the earnings cycle, things are much less clear-cut and a little more complicated. Hand in hand with this, however, there occur more marked price fluctuations, and these can be exploited. Here are several basic rules to which we endeavour to adhere in times like these.

The equity market is a market of individual titles

Just because the earnings of companies generally are decreasing does not of course mean that profitability of all companies is falling. Even in this phase of the earnings cycle there are plenty of companies which are still growing their earnings – and sometimes by quite a lot. At such a time, however, investing requires very careful selection of individual investments.
In a strongly bullish market, it oftentimes scarcely matters what one buys because everything an investor touches goes up. This is not the case today. Most equity prices have been below their highs for the past year and a half, often by tens of percentage points. The European index is about one-quarter below its all-time high while the US index is only barely so, although it should be said that the latter is held up by a handful of large (and also not very profitable) companies, and beneath the surface there lurks a skulking bear market.

The US market as a whole is trading on a P/E of 24.2 if its current level is measured against the last known earnings from March 2016. Although this is a relatively high multiple, not all equities are this expensive – not by a long shot. The situation can look quite different if we exclude all those companies having large weightings in the index but almost no earnings (Amazon) or only rather small profits (Facebook), as well as companies that are perpetual loss-makers

(Salesforce, LinkedIn, Tesla) and the entire energy sector, which is currently in loss and has a 7.4% weight in the index. After stripping these out, what remains is far less expensive. Then, too, the European stock market is always open to us, and it is much less costly as a whole.

Numbers quality

When profits go down, company managers have stronger incentive to cook the numbers. Almost every company today reports two sets of numbers – one according to the accounting standards (reported earnings) and the other according to its own, frequently very loose rules (operating earnings). Operating earnings exclude a number of expenses that, according to the managers, conceal (i.e. decrease) a company's real profitability. Although management's proclaimed objective is to provide investors with a clearer picture of the actual profitability, in fact this is almost exclusively an effort to make themselves look better. The most frequently excluded expenses consist of what are termed one--time, extraordinary, and restructuring expenses but which in fact recur more or less every year; remuneration to employees paid in shares which are said not to be expenses at all; and one-time asset-value write-downs which are in fact admissions either that past reported profits were overstated or a promise that future profits will be overstated.

To illustrate how much the reported and operating profits differ, consider that while the most recent reported earnings per share in the US were USD 86.44 (as noted above), the most recent operating profits were USD 98.61. The difference is 14%. In many companies, this difference is even much greater. Meanwhile, there are a number of other companies which do not engage in such manipulation. In any case, we at Vltava Fund always make our own judgement regarding a company's true profitability and take care not to be misled by what management tells us.

Reasonable expectations

Most entities involved in capital markets have a predisposition towards unreasonable optimism. This can be due in part to people's natures, but also it can have a lot to do with looking out for one's personal gain. Managements often tend to present the situation and outlook of their companies as better than they actually are, doing so not only because their own remuneration depends on investor expectations but frequently so, too, do the companies' operations, results, and sometimes even their survival. Analysts and brokers are usually overly optimistic, as well. Sometimes they themselves believe the overly rosy scenarios which they portray, but sometimes they embellish things intentionally because it brings in the business.

Again to illustrate: a year ago, the consensus of analysts' earnings expectations for the first quarter of 2016 was 29% higher than what it turned out in fact to be. The consensus earnings forecast for the full year 2016 was 18% higher a year ago than what it is now. For the full year 2017, analysts expect 17% growth in earnings. Both of these estimates will probably prove to be unreasonably optimistic.

Although we do not have our own forecasts as to the profitability of the market as a whole, we do of course make our own estimates for those companies we own. We currently estimate the overall year-on--year increase in earnings among our companies will by approximately 5%. Whether we are overly conservative or much too optimistic, we will see in a year. It is very probable, however, that the error in our estimate will be much less than that of analysts collectively for the market as a whole. We had similarly modest expectations a year ago, and these proved to be relatively accurate. Today, three-quarters of the companies in our portfolio have higher earnings per share than they did a year ago.

Long-term thinking and patience

A company's value depends upon the entirety of its long-term future, which means that profits in the latest quarter and even year influence it only minimally. Nevertheless, the stock market mostly responds – and sometimes very much unduly so – specifically to changes in earnings in the latest or current period and ignores long-term value.

This creates excellent investment opportunities and gives rise to possibilities for a certain kind of time arbitrage. An overwhelming majority of market participants are under pressure due to their business orientations or competitive environments to achieve good results within short time horizons of days, weeks, or maybe two to three months. This compels them to pursue speculative moves offering them at least a little hope of immediate profit while at the same time completely forgoing investments where there is low hope for momentary gain but the probability of attractive long-term profit is high. It is precisely opportunities of the latter sort which we pursue. This requires patience, however.

For example, we have one title in our portfolio the price of which is not even half of what we believe is its value. The company is regularly and massively buying back its own shares. This year it is going to acquire nearly 20% of its own equity. It then cancels the shares which it buys and the other shareholders see the proportions of their ownership stakes increase. It is interesting that not only does the company not need to borrow money for these purchases but its own debt is diminishing at the same time. If it can acquire its own shares for less than half their value, then with each share it purchases the value of the remaining shares outstanding increases nicely.

If we carry this situation forward ad absurdum, then after 5 years of acquiring its own shares at the current rate and at the current price we would be the sole remaining shareholders and our share would have a value of several billion dollars. This is not going to happen, of course, because in the meantime there would occur such a huge gap between the share's price and its value that the price would have gone up long before this. We do not know when this will happen. One might say even the current difference between the price and value is so large that one must be blind not to see it, but the price has not yet responded. We do not mind this at all, however, because the longer the price stays low the more shares the company buys back cheaply and the more the value of the remaining shares increases.

Of course, there remains the possibility that it is us – and not the market at all – who has gotten it wrong. We realise this, but on our side there is such a great margin of safety in the form of the price–value spread that the probability of a good outcome is substantially skewed in our direction. Moreover, we have additional companies in the portfolio which are regularly and over the long term buying back their own shares, even though those are not such extreme cases.

Growth and its price

In times of generally dwindling earnings, earnings growth in individual companies is rarer and investors tend to overpay for it. We strive to avoid this, because it is apparent that **not all growth creates value**. There are a number of examples of companies that grow in terms of sales and perhaps even earnings despite that such growth does not create value. The market sometimes looks only skin-deep and it often will push up the prices of those shares even for quite a long time. A day of reckoning will someday come for such companies, however, and we do not wish to be in attendance for that. **Even growth which does create value can justify only a certain, limited price.** Investors often pay much more for growth than it is in fact worth. This we also avoid. We always endeavour to measure price against value. Buying growth at all costs would be a mistake, and sometimes even a company whose earnings are diminishing over the long term can constitute excellent investments if their share prices correspond to what is actually happening.

Everything passes

Everything that cannot last forever must one day come to an end. This phase of declining earnings, too, must pass and a phase of rising profits will begin. It would be marvellous to know when that day will come, but that would be too much to ask. It is possible that day was in the first quarter of this year. Earnings should be higher in this quarter due to a contribution from the energy sector, but you know how things can go when making predictions…

At current profit levels among US companies, their overall return on equity (ROE) is 11.6%. This is less than the long-term average, and it means that the capital companies presently have invested in their businesses should earn somewhat more than it does now. This would also signal higher earnings in future.

Changes in the portfolio

We sold out two positions, both for similar reasons.

Greenlight Re is a reinsurance company the investment portfolio of which is managed by David Einhorn, one of the best investors of the current generation. Our investment thesis was founded on the combination of a solid reinsurance business, good results for the investment portfolio achieved with a small exposure to the market, and the company's willingness and ability to buy back its own shares in case their price would markedly drop below the level of their fundamental value. As time passed, cracks began to appear in our assumptions.

Last year was a bad investment year for David Einhorn. You could say it was even worse than in 2008. This sometimes happens to even the best of investors, and we do not believe that he would all at once have lost his investment abilities. In our eyes, 20 years of good results carries more weight than does 1 bad year. Nevertheless, we were dissuaded by something else. Recently, there has been an increasing number of cases when we did not understand the reasons for some of his investments. We are conscious of the fact that the error could be at our side. After all, Einhorn is a legend and we are still rookie investors of some local importance. Nevertheless, we do not regard it as proper blindly to believe in something without understanding why.

Another reason is that the entire reinsurance sector is facing – and apparently will be facing for a long time into the future – low returns due to there being excess capital deployed in that sector. Finally, there was the realisation that when at the end of last year the shares of Greenlight Re were trading significantly below book value the company could not properly utilise this opportunity to repurchase its shares because, being a reinsurance company, it also had to maintain its capital levels as necessary for covering insurance liabilities.

Therefore, we decided to sell the shares. We lost 14% on the investment. This is the first title among those we bought in the past 5 years which we sold out of at a loss. Even though we endeavour that all of our individual investments will be profitable, sometimes it is better to accept a loss and redeploy the money elsewhere.

Oaktree Capital is an assets manager specialising primarily in bonds of various types and qualities. It is probably the best firm in the world within its field, and we have great respect for it. Nevertheless, its future returns will be substantially and negatively influenced by persistent low interest rates. It will be better to invest our money elsewhere. We earned 41% on Oaktree.

We bought two new positions – one in the US and one in the UK. We were most active at the very end of the quarter, when the sharp market reaction to Brexit brought great dislocations in equity prices due to a combination of the initial shock, stop-loss orders, and forced sales. In our opinion, Brexit will be seen in hindsight as a good buying opportunity, just as was the first Greek crisis 5 years ago.

On behalf of the entire Vltava Fund team,
I wish you a pleasant summer.

Daniel Gladiš, July 2016