VLTAVA FUND

Dear shareholders

Vltava Fund's NAV decreased by 7.8% in 2015 and assets under management reached 1.9 billion Czech korunas as of 31 December 2015.

Our largest equity positions at the start of 2016 were Berkshire Hathaway, WH Smith, Teva Pharmaceutical, BMW, and Total Produce. Our portfolio is concentrated into investments which we consider to provide the best combination of returns and risk. Sufficiently attractive investment opportunities are rather rare, and therefore we endeavour to utilise these to their best advantage. Our 10 largest positions make up approximately 70% of our portfolio.

In the current market, the Fund's portfolio is priced at about 11 times the earnings of the past 12 months. This means that for the past year the net profits of our companies amounted to approximately 9% of their market capitalisation (i.e. their earnings yield, which is the inverse of P/E). In our opinion, that is an attractive yield considering the quality and prospects of these companies. This number stands out particularly in comparison to interest rates that linger close to zero. By our estimates, the fundamental value of our shares stands about one-fifth higher than their current prices. A fundamental valuation is not something static, however. Rather, it develops through time. In the case of our portfolio, it is quite solidly growing. At the end of this year, it should be on the order of one-third higher than today's prices. This ought to create sufficiently strong upward pressure on the prices of our stocks to push them higher.

In the past seven years, which means from the Great Financial Crisis and at the same time from the change in our investment strategy, Vltava Fund's NAV has grown to 4.2 times where it had been. More precisely, it has risen by 324%. While it is true that the past seven years have been very good for equity investments, our results are nevertheless very good by worldwide standards. This result places our fund among the very top funds in the world.

To achieve such returns, it is necessary also to have a little luck, and it is obvious that they are not sustainable over the long term. Be that as it may, we believe that we will remain among the best funds for a long time to come and that our returns will be good. Your expectations, though, should be realistic and should not be based upon returns from the past seven years. Last year reminded us all that share prices can also go down.

In the next part of the Annual Report, you will find quarterly letters to stockholders from the past year. Taken together, these present a picture of our investments and opinions from last year.

We thank you for your support and goodwill through the years gone by and we look forward to our co-operation in the years to come.

Daniel Gladiš, February 2016

VLTAVA FUND

WHAT IS REALLY NORMAL?

Dear shareholders

In the first quarter of 2015, the Fund's NAV declined by 0.6%.

Are negative rates normal?

It frequently happens that people consider current events to be exceptional, but it usually becomes clear in hindsight that nothing that was happening was truly extraordinary relative to history. This occurs because people tend to ascribe greater importance to present developments than they are due. At the risk of making the same mistake, I nevertheless maintain that in certain respects the current situation on financial markets has no historical parallel and is entirely exceptional.

The world's main central banks have never before dared to carry out such enormous experimentation. By their combined efforts, they have pushed interest rates to an historic super low in not only nominal but also real terms. Interest from commercial banks' deposits at central banks is in some cases negative (e.g. at the ECB, in Switzerland and Denmark) and practically zero in others (e.g. in the U.S. and Japan). Yields to maturity on government bonds from a number of Western countries hover around lows not seen in several hundred years (e.g. Germany, France and the Netherlands) and in some cases are even negative (Switzerland and Germany). Finland even recently issued five-year bonds with negative yields.

Why are central banks doing this? Their logic is driven by efforts to force consumers to save less and spend more, induce banks to replace low-yield bonds with loans to businesses, reduce businesses' and governments' costs for servicing debt, and induce investors to invest into riskier assets (thereby driving up those assets' prices and achieving wealth effects which should result in greater confidence in the economy and greater consumption).

Central bankers are only flesh and blood, however, and they make the same cognitive errors as do the rest of us. One such mistake might be their present herd-like behaviour. As I follow them in the media, one thing stands out to me. It seems to me they have absolutely no doubt as to the correctness of their actions. That makes me very nervous. They copy one another's behaviour, and the fact that they all act in the same way gives them a false sense of security. The history of financial markets has seen many instances, however, when what most people considered to be correct was eventually proven to be a mistake.

What does current evidence say?

A look at the real economy does not suggest, however, that the result is very favourable. Household consumption is weak. Might this not be caused by negative real rates forcing people to save even more? Companies are not investing much. Might this not be caused by their being restrained by consumers' cautious behaviour as well as extraordinarily low returns to capital? Banks have excess cash, but loan volumes continue to grow only very slowly. Might this not be caused by the fact that companies are investing rather little? After seven years of "saving", governments have more debt than ever before and have implemented practically no long-term structural reforms. Might this not be caused by their being lulled by cheaply accessible cash and low borrowing costs?

The sole thing the central banks have managed to accomplish is to drive up asset prices. This distorts the overall impression of their policies. Wealth effects act like a narcotic and make other problems seem less urgent. How would we evaluate the overall situation if equity markets were lower by, say, one-third?

Deformed capitalism

If there is one variable in economics that can be called key, it is the price of money. However, central banks have deformed this value so much that it cannot fulfil its role at all. It deforms market relationships and returns to capital. For capitalism to work, the price of money must be reasonable. Today, it certainly is not. **Two-thirds of government bonds issued by western countries today provide negative real returns. Central banks in countries operating on capitalist principles have decided that real returns to capital will be negative.**

How should such an economy work correctly? The deformation affects not only the price of money, but also people's thinking. I believe that at some point

in future, when we look back at today, we will find it unbelievable that many bonds were trading with negative real yields. Nevertheless, most investors today see it as normal. If that were not the case, bond prices would be lower. When something clearly insane is considered normal, then perhaps the entire contemporary society has gone mad.

Implications for investing

Investors today have lost their perspective and regard the current state as normal. Few people today fear a substantial rise in interest rates. Most investors rather tend to extrapolate the present state into the future, and this is very dangerous. A great source of risk can be found in investors' very impression that risk is low.

Future yields on all asset classes have adjusted to low interest rates. In other words, they have decreased. Today's prices on bond and equity markets (and, of course, prices of real estate, land, art, gold and other assets) can be justified only against the backdrop of abnormally low interest rates. If these rates would begin to rise, the prices of all assets will come under pressure.

The future is always uncertain, and matters will obviously develop in ways other than we expect. We are aware of this fact, and we therefore endeavour not to gamble with our investments on any particular future development scenario – neither that rates will rise nor that they will remain low. We endeavour to invest so that we will be successful in either case.

We have almost nothing to say about the direction of markets (which in no way differentiates us from other investors), and it would be naive of us to try. We can, however, choose whether our portfolio will be aggressive or defensive. At present, our considerations unequivocally lead us to a defensive stance. This means being very selective in choosing equities and not being afraid to hold more cash if we cannot find sufficient investment opportunities.

Equity markets have recently been relatively calm. Volatility is low, but it would probably be a mistake to regard the markets today as stable. Volatility and stability are two different things. Equity valuations that have Shiller's cyclically adjusted P/E approaching two standard deviations above its long--term average, absurd bond prices, and significant recent movements in certain currencies – these all are elements of instability which must be recognised. It is therefore no coincidence that the proportion of cash in our portfolio is the highest it has been for the past 7 years.

Changes in the portfolio

We sold three titles: Catlin, Asian Citrus and Humana. Coincidentally, all three are among our oldest investments. We held them for 6–8 years. We had a different reason for selling each one.

Catlin is an insurance company we began buying in 2008. It was one of our favourite positions. Stephen Catlin, who founded and still manages it, has built an excellent company. We would have been happy to hold it for maybe another ten years. In January, however, Catlin was bought by XL Group. In the newly merged company, XL Group will hold the majority, its management and culture will dominate, and no one knows how long people from Catlin, including Stephen Catlin, will remain there. We are not interested in the merged company's shares, and we have therefore sold Catlin. We are definitely not complaining, though, as we have more than tripled our money. Our overall return was 211%.

We first bought **Asian Citrus** in 2007 and gradually built our position over the following two years. From our average purchase price of approximately GBPp 20, the share price grew to GBPp 80 in 2010 and the company appeared to have a great future ahead of it. At that time, however, the company began a long-term decline. Almost every misfortune possibly imaginable in fact occurred: typhoon, torrential rains, disease, an overpriced acquisition, megalomaniacal expansion and, most especially, poor corporate governance and management's poor relations with shareholders. We spoke with management many times, met them in person, wrote letters to the board of directors, joined with other dissatisfied shareholders in votes at the general meeting, but it led nowhere. Asian Citrus was a stock for which just as in Jára Cimrman's operetta Proso (Millet) instants of high expectations alternated with instants of disappointment. We gradually began reducing our investment and have finally completed its sale. In hindsight, we should have sold it long ago. It is only because we sold some of the shares close to their peak five years ago that we earned any money overall. Our annualised return was nevertheless negligible.

Humana is a health insurance company we bought at a low, post-crisis price in 2009 for less than five times earnings. Prices were so low then! Now, we have sold it for approximately 20 times earnings and at a price almost five times higher than what we bought it for. The price simply appeared to us to be too high. Our return was 380%.

We did not buy any new positions, but only on several occasions added to positions we were already holding. The most recent such occasion, as it happens, was this morning before I began writing this letter.

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

Daniel Gladiš, April 2015

A LACK OF SEX

Dear shareholders

In th e second quarter of 2015 the Fund's NAV decreased by 2.4%.

The alternative scene

In my previous letter to shareholders, I wrote about the bubble in bond prices. Although their prices have since turned downward – and at times quite significantly – they remain ridiculously high. Today I want to focus in on some other asset types. These are sometimes referred to collectively as "alternative" investments, and this might create an impression that they are something above standard. According to those who promote them, alternative assets also require alternative approaches to their valuation. **In fact, however, it applies to all investments – whatever label we put on them – that their value equals the present value of their future cash flows and that the relationship between price and value is decisive.**

Markets in general have a cyclical nature, and when the cycle is in its upper phase there begin to appear signs of maturity that include certain side effects. Generally, prices are higher, investment opportunities fewer, and the access to cash cheaper and easier. On the investors' side, meanwhile, we see underestimation of risks and frequently the investors' mistaking the results of a bull market several years in the running as evidence of their personal ingeniousness. On the side of companies offering financial products, there is a never-ending cleverness and capability to exploit this situation and to sell everything they can. Unsuspecting investors then venture into things they do not understand in the least but nevertheless feel good inasmuch as they took an alternative route.

Private equity

It seems almost everybody and his brother is founding a private equity fund these days. The word private sounds nice. Everything private is good, is it not? This word has a different meaning in this context, however. It is used in contrast to the word public and means that these are investments into shares (equity) of companies that are not publicly traded. So, what are their advantages? These shares have low liquidity and their pricing is not transparent. The basic idea of private equity is to buy controlling shares in companies, then manage them for some time, and finally, utilising large quantities of debt, either bring them to the public market or sell them on to a third party. **Private equity sounds alternative and appealing. A more accurate name for this, however, would be "leveraged investments into untransparently priced and illiquid shares".**

But what is so important about liquidity and transparency? We could sell 90% of the Vltava Fund portfolio at any time within a single day while not influencing the prices of the shares we hold. Even though we are long-term investors and our investment horizon is 5 years and more for the individual investments, high liquidity has its option

value. A situation can arise wherein this will be invaluable. The liquidity of private equity investments is exceedingly low, and in certain more critical periods it is practically zero. Little wonder, then, that private equity funds are constructed as closed, which means that investors cannot leave the fund for a number of years. As things go in life, the inaccessibility of one's money in private equity investments usually appears to be a handicap only at such time as one most needs it.

If we at Vltava Fund hold, for example, Walmart shares, then there cannot be the slightest doubt as to what is their price. One needs only to look at the market. We can have our own idea as to what is their intrinsic value and what their price should be, but a market price is always used for valuation. We have no influence on it, and it is therefore entirely transparent. This valuation method is called "marking to market". Private equity funds cannot use it, because their companies' shares are not traded anywhere. They are using the "mark to model" method, and that means that they value the companies in their portfolios according to some model. Even though they always avow that this is an independent, expert, and fair approach, this assertion is wholly open to dispute. First, the models used are either the private equity firms' own internal ones or those of companies they hire and pay. There is no independence. Second, there is no objectively defined company value. This will always be a subjective and imprecise estimate. Here, creativity knows no bounds. For example, a multiple of the company's EBITDA is very frequently used in the value calculation. **Every professional investor knows very well that EBITDA is a wholly nonsensical indicator in this respect, and that it is used either by those who do not know what they are doing or by those who know precisely what they want to achieve by using it. "Mark to model" then frequently transforms to "mark to fantasy".**

Low liquidity and low transparency cannot be denied. What arguments do sellers of private equity use to balance these out? Essentially they use three arguments.

First, they maintain that they can find excellent companies and then manage them excellently. Everyone says that, but this is not quite so easy in practice. Offering a financial product and managing a company are two entirely different things requiring wholly different skills. In my career, I have done both and I think I can judge that a little. I do not want to wrong anyone, however, and I concede that some people have both sets of skills. The question is, however, whether investors into private equity firms can know that in advance. When I imagine how many excellent companies with demonstrably excellent managers are traded on public markets, it seems to me almost futile to venture half-blind into private equity. Why clamber over a tall concrete wall if you can just step over a little picket fence?

Second, private equity investments are allegedly less volatile and therefore less risky. Of course, if the sellers of private equity funds value their investments using their own models, then their valuations will certainly be less volatile than, for instance, those given by the equity market. But then we are comparing apples to oranges and reality to dreams. When during 2008–2009 equity markets fell by a half, what happened to prices of investments held by private equity firms? They fell by at least as much, and in many cases they became entirely unsellable. **The fact that this had no effect on the valuation models of private equity firms is no proof of a less volatile business; rather, it proves that valuation methods had diverged from the market reality.** In addition, I believe that its working with substantial debt makes private equity much more volatile and risky than it is presented to be.

Third, private equity allegedly brings higher returns. That may be true for the managers of those funds but not for their investors. The fee structure, long-term closed character of private equity funds, and assets valuation using their own models create a great asymmetry of returns. When the fund fares well, its managers collect a large proportion of the returns; when the fund fares badly, the investors bear the losses.

The business model of a private equity fund is usually based on several crucial steps: Promise unrealistically high returns, collect the investors' money and lock it in for as long as possible, and set up the fee structure so that the managers have guaranteed high returns almost without regard for how successful they are. That is the sad reality. For the first several years, when the assets are valued in accordance with internal models, good returns – at least on paper – can be counted upon. And when push comes to shove and it perhaps appears that returns are much lower than promised, there is always some trick up the sleeve to cover it. Such as by

diluting the failure with new money from unsuspecting investors. The show must go on!

Farmland

In recent years, there has been a literal mania to grab up farmland in the Czech Republic. The main arguments are as follow: the price of land is always rising, its price is low in comparison to Austria, and the amount of land does not increase. Such arguments can scarcely be resisted. It is not true, however, that the price of land is continually increasing. All one has to do is to look at other countries and into history to find very soon that not only do the prices of land not always rise, but, from time to time, they also decline – and even significantly so over the long term. Yes, land is cheaper in the Czech Republic than, for example, in Austria, but it is not exceptional in history for apparently comparable assets to be valued differently even for decades. While it is true that the amount of land does not increase, the crop yields derived from it do, and at the same time the number of people in Europe is decreasing. So perhaps even the point about its amount not increasing is not so clear-cut. In any case, the value of an asset does not depend on whether its amount increases or does not, but on the returns that it brings.

Returns from farmland are very low in the Czech Republic, on the order of 2.5–3% per year. After tax, therefore, we get a level of about 2%. That is not much. Paying 50 times the annual profit for an asset is quite a lot. Let us consider just for the sake of comparison that equity markets are considered to be rather expensive today even though as a price multiple of annual returns they only are about one-third so high. Equity indices would need suddenly to triple for equities to be as expensive as is farmland in the Czech Republic.

Nevertheless, a 2% return can seem sufficient to someone in the light of low interest rates. **What happens to land prices, however, if for example interest rates return to their normal non-deformed level? The investors will demand higher returns from land, let us say 6–7%. This can be achieved in two ways: by a more than doubling of the rental price or a marked decrease in the land price.**

Critical comments on investments into private equity concerning low liquidity, low transparency and valuation on the basis of models also apply for investments into farmland. Nevertheless, they are very popular in the Czech Republic. We should remember one wise rule, however, and that is when a majority of investors are convinced something is a good investment, then it probably no longer is.

High-yield bonds

The name high-yield bonds is only a euphemism for bonds issued by high-risk debtors. In English, they have the beautiful nickname junk bonds. When interest rates are zero, any bond yielding more than 5% looks tempting, and in the Czech Republic they have been on a tear. **Investors may not realise, however, what is the greatest risk connected to them – and that is the risk that the bond will not be repaid.** This risk exists for every bond, and the size of that risk should be weighed against the amount of its return. Investors are usually unable to judge this risk by themselves, and, truth be told, they mostly do not even try very hard to do so. They are blinded by the fixation on yield. However, the level of yields for bonds in this category today does not at all offset the risk undertaken. This is given by the record-low rates on government bonds and at the same time record-low spreads between these and high-yield bonds. When we sum these two numbers, we get a total yield on junk bonds which is lower than what under normal circumstances would usually be their spread return alone.

Everything is interrelated

The price levels of the individual asset classes do not develop in a vacuum. Rather, they are mutually related. If we consider equity markets to be rather expensive, then it would be naive to believe that this would not affect the prices of private equity investments. If interest rates are low and money is generally easily available, then it would be naive to believe that it would not affect prices for land. And if government bonds are undeniably in a price bubble, then it would be naive to believe that this does not impact upon high-yield bonds.

A lack of sex

Warren Buffett has remarked that in 1974 he felt like an oversexed man in a harem. Equity prices were so low that he literally did not know where to invest first. **Today it seems to me that some investors are behaving as though, by contrast, they have had a chronic lack of sex. They take almost anything regardless of price.**

We never want to reach this state. We endeavour to stick to what is in our circle of competence – publicly traded equity. The possibilities offered by this market

are immense. In addition, our investments are very highly liquid and transparent. You know which companies we own and you can also follow their development yourselves.

I do not hold a patent on brains, and I am aware that I can be wrong about many things. Nevertheless, I have been active in the markets for almost a quarter century and I can see certain things repeating again and again. As investors, you pay us for taking care of your money and, indirectly, for saying what we think. Perhaps this letter will help you in your own investment deliberations. When I consider the individual investments, I frequently ask myself what Buffett would do. When you find yourself tempted to take some alternative route, you might try that as well. It helps.

Changes in the portfolio

We sold nothing and we have two new positions. One is a company in the financial sector, and its business is based on intermediating transactions without the risk of trading on its own account and without great need for its own capital. The company's free cash flow is at an inflection point and it should bring nice returns for many years to come.

The second company produces specialty industrial goods. It is a company with a very strong position as well as a distinct and persistently sustainable competitive advantage. We have been following it for many years, and we finally saw the long-awaited drop in price and good buying opportunity.

In addition to these two new positions, we have significantly expanded one of our existing European positions. At times an even irrational paranoia prevailing on the market due to developments in Greece brought excellent prices and we have taken advantage of these accordingly. I would almost like to thank the Greek government for helping create such investment opportunities. Apparently, this will not be the last such opportunity…

Daniel Gladiš, July 2015

RISK-FREE STOCKS

Dear shareholders

In the third quarter of 2015, the Fund's NAV decreased by 8.1%.

Our previous letter to shareholders evoked a great deal of reader response. We are having a small debate concerning the cause. I, of course, believe it was because the letter was a beautifully written investment classic. However, my colleague Jan Žák claims it was just because the letter's title included the word sex. To settle the matter, I have decided to title this letter entirely sexlessly "Risk-Free Stocks".

Properly defining risk

At first sight, the connection of "risk-free" and "stock" seems like an oxymoron. Most people even consider the word "stock" as almost synonymous with risk. In general, however, stocks are much less risky in comparison not only to the ideas in investors' heads but also to other asset classes. **Shares in certain companies can even be considered risk free by definition.**

Now, I will attempt to explain step by step how we reached this conclusion. Let us begin with a quote from Warren Buffett:

"We … [define] investing as the transfer to others of purchasing power now with the reasoned expectation of receiving more purchasing power – after taxes have been paid on nominal gains – in the future. **More succinctly, investing is forgoing consumption now in order to have the ability to consume more at a later date."**

This definition leads to several important conclusions. First, **the investor's greatest enemy and at the same time his or her motivation is inflation.** If over the long term inflation were zero, or even negative, we would not need to invest because money would not lose its value. Inflation is positive over the long term, however, and

even at current low rates money will lose half its value over two generations. Even just a slightly higher annual rate of 2.5% would destroy three-quarters of that value.

Second, Buffett's definition clearly shows that investing is a long-term matter. The investor's objectives must also be long-term. **Investing is not about weeks or months but rather the next decade or two.**

Third, **what is main risk for the investor? It is that he or she fails to achieve his or her objective, which is to increase the real value of his or her money over the long term.**

The effort to achieve this objective can be blocked essentially by two things: selecting an investment asset class with a low probability of achieving the objective and permanent loss of capital, which could occur within the selected asset class. Therefore, if we accept Buffett's definition of investing and the objective which follows from it, **the greatest investment risk comes from poor choice of investment asset class and poor choice of individual investments within the selected asset class.**

This risk definition of ours is not customary, and it represents by far a minority view. We nevertheless regard it to be correct. Mainstream theory defines risk otherwise, namely as volatility. Simply said, the less an investment asset's price fluctuates the less risky it is. There undoubtedly exists a certain relationship between risk and returns. The more risk an investor takes, the greater the compensation in the form of returns he or she requires. This is entirely logical. The opposite relationship would make no sense. If we equate risk with volatility, however, this should mean that investors seek more volatility in order to obtain more profit. Have any of you ever met such an investor? I have not.

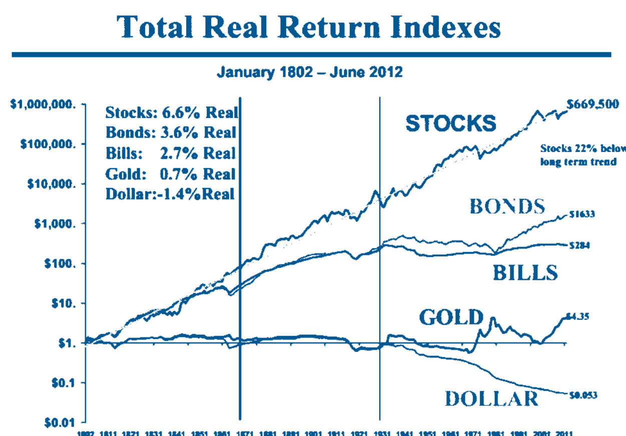
When risk is defined as price volatility, the assets considered the least risky will be those for which prices fluctuate the least – cash, bank deposits, treasury bills, short-term government bonds. The problem, however, is that in practice these assets prevent the investor from achieving his or her objective – to increase the real value of his or her money over the long term. **What good does investments' low volatility do an investor if they do not enable him or her to achieve his or her objective? Are such investments not rather too risky?**

Defining risk as volatility is wrong. It deforms investment considerations and leads investors to poor asset choices. **In the long term, volatility is practically irrelevant.** Over the past 30 years, shares in Buffett's Berkshire Hathaway recorded four big drops in the range of 37–51%. For many investors, this is unacceptable volatility which would prevent them from investing into this equity. For a long-term investor, however, it is an entirely usual phenomenon affecting even the highest-quality shares. Whoever bought Berkshire shares for $1,300 in 1985 and holds them today at a price of $200,000 is certainly not complaining about the temporary volatility they needed to wait out.

I am aware that the long-term returns on Berkshire shares are exceptionally high and that this is not typical for common equities. However, I want to use this example to demonstrate something else. Buffett is one of the best CEOs in history. He minimises the errors he makes, allocates capital in an exemplary fashion, and acts completely in shareholders' interest. However, all this cannot prevent the shares of the company he manages from undergoing considerable price fluctuation from time to time. That is simply how it goes. It is important truly to understand that this is not a source of risk.

Returns on individual asset classes

A glance at the following graph makes it clear that not only are stocks the asset with the highest returns over the long term, but they also have the least deviations from their long-term trend.



Source: Jeremy Siegel, Stocks for the Long Run

If we accept the initial assumptions that
1. the investor's objective is to increase the real value of his or her money over the long term,
2. the investment horizon is long,
3. volatility is not only not considered to be a source of risk but is essentially ignored (in the ideal case it can even be used to the investor's benefit), and
4. equities hold the greatest hope for positive real returns and so also the lowest risk of not achieving the investor's goal,

then it is evident that stocks must form the basis of every investment portfolio.

Risk-free stocks

Investing in equities does entail risk, of course. It is not risk of price fluctuations, however, but rather risk related to individual companies' operations. These risks can be divided into several categories:

- Technological
- Cyclical
- Regulatory
- Currency
- Financial
- Operational
- Managerial

Among the many companies whose shares are traded on the markets, some can be found which minimise such risks. We therefore consider their stocks to be risk free. First, they are in the class of assets the high returns of which over the long term minimise the risk that the investor will not achieve his or her goal. Second, they also minimise the second greatest risk, namely permanent loss of capital. **A portfolio comprised of stocks of such companies can be considered risk free. It will very probably produce positive real returns over the long term and with minimal risk of permanent loss of capital.** As investors, of course, we need not limit ourselves when assembling a portfolio to only risk-free stocks. These provide only a starting point. Our task is to study individual companies, form an understanding of the amount of their business risk and possible investment returns, and then select the best combination of risk and returns. Most investors strive for an ideal combination of risk and returns, but the alpha and omega of such efforts is the correct definition of risk.

Imagine two identical companies. They are absolutely the same and differ only in the fact that the shares of one are traded on an exchange while those of the other are not. No one would be likely to assess the risk of the company not traded on an exchange according to its price volatility because its price is not available. Its risk would clearly be assessed according to the aforementioned categories related to the company's operations. Well, risk of the company traded on an exchange should be assessed in exactly the same manner. **The definition of risk cannot simply change based solely on whether stocks are traded on an exchange or not.** Trading on an exchange is only an additional advantage that enables us to respond to extreme market moods and potentially achieve higher returns.

Changes in the portfolio

Shares in **Precision Castparts** (PCP) are on their way out of the portfolio. PCP makes special metal products and components, in particular for the aviation and energy industries. We have been watching the company for several years, but it always seemed expensive to us. We were eventually rewarded in spring by seeing its price drop by about one-quarter from its previous high. We therefore began building our position. We were pleased when about one month later it became apparent that Buffett had also begun buying PCP in the first quarter. Given that neither equity markets as a whole nor PCP share prices in particular were rising, we gradually bought more and more PCP shares for increasingly better prices. It seemed there was no reason to rush. But one Sunday morning in August, we discovered that Buffett's Berkshire Hathaway was purchasing PCP as a whole. At that time, about 5% of our portfolio was in PCP and we had built approximately two-thirds of our intended position. Our feelings are therefore mixed. On the one hand, we are pleased that Buffett sees value where we see it, and of course we are pleased by the quick gain of about 17%. On the other hand, we like PCP a lot and we had assumed that over the long term it would become one of our main positions and would make us a great deal more money over time. We can find small comfort in the fact that we will continue to own PCP through our shares in Berkshire.

We bought two positions. One in Canada and one in the US. The Canadian company is one of our old acquaintances. We owned it during 2004–2006. We sold it then because we had reservations about the actions of the main shareholder of the time, the founder and director in a single individual. That person left several years ago, however, and we are quite partial to the current management. It is a big, global, and financially strong company, currently available for less than nine times earnings.

Our second new purchase is from the financial sector. We systematically endeavoured to find a relatively young company with an established and, in particular, expandable business model. We eventually succeeded in finding such a company, and we believe it will one day grow to many times its current size. We therefore expect many years of high growth, and at its current price we need not pay for that upfront.

We were relatively active this quarter, including in expanding several existing positions. Prices are falling, and after a long time we have more good investment opportunities than we can use. That is a very nice problem to have. The influx of new money into the fund and the sale of PCP have provided us cash enough for further purchases, and all we can do is wish for prices to become even more advantageous than they are already.

Daniel Gladiš, October 2015

WHY NOT TO INVEST WITH US

Dear shareholders

In the final quarter of 2015, the Fund's NAV grew by 3.4%.

I often meet people who come to us with interest to invest into Vltava Fund. In most cases they already know a lot about us. They read our letters to shareholders, know our results, and maybe even have seen us at some of the lectures and conferences. One can essentially say they are inclined towards investing with us even before we meet and our meeting ought to serve them rather as an avenue for confirming their opinion. When discussing our investments and our investment philosophy I have the impression that subconsciously they are just waiting for arguments that would confirm they are doing right by preparing to invest with us.

When I think about such a meeting while sitting quietly in the evening, I frequently am not completely satisfied with how it had gone. One should not look for confirmation as to the correctness of one's opinions by seeking the opinions of others who are of the same mind but rather by searching out opposing opinions and only then considering whether the original opinion remains unchanged. I can talk about the reasons to invest with us for hours, and I enjoy doing that, but part of the discussion should always be dedicated to reasons not to invest with us. These exist for every investment, and our fund is no exception in that regard. Described here are the main ones, which I have divided into academic, practical, and human.

Academic reasons

I like to say that investment is not a natural science. It is nothing like physics, for example, wherein an experiment in the laboratory under identical conditions always has the same outcome. There are no fixed, natural laws in investment. For this reason there are very few, if any, aspects of investment which can be called objectively correct. Nevertheless, investment is not at the other extreme either, which is to say there is no place for chaos and complete randomness. The reality lies somewhere in between. Although we cannot apply universally incontrovertible laws, there do exist certain principles upon which one can rely. These ensue from the existence of motives shaping the flow of capital and are supported by historical data. Their application will nonetheless always be associated with a great deal of the investor's subjectivity.

In my books, university lectures, these letters, and in other appearances and publications, it can be seen that our investment philosophy is clearly formulated and thought through (or at least we think so). This, however, still does not mean that it is correct. Essentially, it neither can be unequivocally confirmed nor unequivocally refuted. Investment is and will remain a thing of probabilities. From an academic perspective, there would certainly be a number of people who would have reservations about our philosophy. After all, regarding certain points we side with a minority opinion. (See, for example, our take on risk and the last letter to shareholders entitled Risk-Free Stocks). We have no problem being in a minority so long as we believe that our thinking is rationally supported. But this in and of itself says nothing about the correctness of our approach.

Our investment philosophy is bolstered by almost a quarter century of practical work, accumulated experience, relentless study, and never-ending deliberation. It is continuously evolving and we steadfastly stand by it. We are nevertheless very well aware that we can be wrong – and not just in certain particulars but even as concerns the concept as a whole. This possibility cannot be excluded, and you should consider this as a possible reason why not to invest with us.

Practical reasons

In one of his older annual reports, Warren Buffett defined investment as "…transfer to others of purchasing power now with the reasoned expectation of receiving more purchasing power (…) in the future. More succinctly, investing is forgoing consumption now in order to have the ability to consume more at a later date."

In fact, money can be treated in only two ways: either used for consumption or invested. A person who invests apparently truly expects that doing so will bring greater consumption in future or at least that the value of one's money will be maintained for the generation of one's offspring. However, greater consumption in future does not automatically mean greater benefit. Consider the following example: An investor has savings sufficient for a long trip of his or her dreams around the world. He or she has two choices: go now or invest the money and in 10 years have the opportunity to take two such trips due to investment earnings. I can easily imagine many people would prefer the first variant. If they go immediately, they will be travelling while younger, may enjoy it more, and will have ten more years to think back on it. The entire trip might also be nicer. People who visited Syria, Egypt or Tibet 15 years ago can see today that travelling into such places now might be impossible or dangerous or that these places simply are not what they used to be.

Alongside the concept of the time value of money there is also the concept of time value of benefit. In many cases, people feel greater benefit from smaller consumption earlier than from larger consumption later on. I can see this even in my own case. If you put a chocolate bar in front of me today or promise me two chocolates in five years, I will not hesitate for a second… People live and think differently, and before you start investing it definitely would not hurt if you would devote some time to such considerations. It has never been prescribed from on high that every human must be an investor. In investing, as in any other activity, one must give up something to obtain something else, and it is clear that many people will not be willing to do such thing. This works in reverse, too, though. When one does not invest then one must also give up something. Everyone must simply consider which direction is better for him or her. This is one of those things regarding which it is no simple matter to find help and each person must decide on one's own.

Buffett's definition also implicitly contains one more very important point – investment is a long-term matter. It is not about the next month or a year but rather a decade or two. Such thinking is alien to many people, and such investment horizon is too remote for them. If you are thinking in the very short term, let us say in a three-year horizon, then our fund probably is not an ideal investment instrument for you. (It is questionable whether one can speak of investment at all in a three-year horizon.) Our investment horizon is 5 years and longer, and we recommend the same to our investors.

Human reasons

Even if we assume our investment philosophy is correct, this still does not guarantee a good investment outcome. We are not perfect machines without emotions. We are just ordinary people with all the usual human shortcomings. As true of all other investors, we also make mistakes and it is fundamentally certain that we will continue to make them also in future. It is possible there will be many of them or that they will be inordinately big, and in such case our investment results will not be good. This possibility can never be wholly excluded. Even in such case as we were to make no mistakes whatsoever – and this will seem paradoxical to many – it cannot be guaranteed that our results will be good. Chance can sometimes (and especially in shorter time horizons) produce results of almost any sort.

I do not want to create the impression that investment is some sort of lottery fashioned out of thin air. That certainly is not the case. If we go back to the idea that investment is a matter of probabilities, then I would say it is probable that our results will be good from the long-term perspective, but it is also probable there will be periods when our results will be below average. That is the way it goes in investing, and not even the

greatest investment legends have been able to avoid that reality.

I know from practical experience that for many people such prospects present an insurmountable obstacle to investing. Price fluctuations and even momentarily plunging prices cause them great emotional strain and stress. On the other hand, there are plenty of people for whom this is not a big problem and they bear it all rather lightly. It is probably unnecessary to remark into which group I classify myself. I do not wish to advise anyone on how to approach investing, but everyone should certainly consider in advance where they belong or where they would want to be.

Investing is not an activity wherein something can be obtained for free. A certain amount of effort must always be made. This applies also to investors investing passively for example through funds. In our activities we do not endeavour to sell our fund to anyone or to attract investors into it. Rather, we try to explain what we do and how we do it, how we think, and what can be expected of us. In the case that does not suit someone, then we are glad that they reached that conclusion in advance and that we can continue on our separate ways. In case someone likes what they see, then we also are pleased and perhaps with time this will lead to an investment into our fund. We believe there exist a number of good reasons for investing with us, and we also confirm these by having invested our own money into the fund. Objectively, however, there also are opposing reasons, and those need to be raised as well.

Changes in the portfolio

We sold our small position in Coca-Cola with a gain of 11%. We had been using the Coca-Cola shares for some time as a temporary parking space for excess cash. Now we have decided to use it for something else.

Specifically, the cash went to buy shares in a company providing special credit services. This is the newest addition to our portfolio. The company was founded in the early 1970s and has experienced, and probably will continue to see, great growth. Profit per share in 2014 was the highest in its history. The new record was broken in 2015, and another will probably be set this year. Our expectations are for earnings per share in 2016 to be 25% higher than in 2014, even as the share price dropped by about 40% from its all-time high over the past year. A company with very much above-average growth was available for very below-average earnings multiples. This was a signal for us to buy. We bought and thought that we would just sit back and watch the share price rise over the long term. Just two weeks after our purchase, however, we had seen a nearly 45% gain in the share price. This presented us a dilemma. We had not acquired the shares to make just 40%. We expect a much larger gain, albeit of course over a longer horizon. A higher share price, however, means a lower future return, and therefore we decided to take advantage of this quick jump in price and sold part of the position. Damn those high prices!

It has been seven years since the market crashed in late 2008. Equity prices had been so low during 2009 that one can scarcely believe it today. Pessimism and fear in investors' minds were at their peak, and with hindsight it is now clear that, due to the low prices, investing into shares had carried minimal risk at that time. It had also been easy to invest in 2010–2012 when it was already apparent that the recovery of economies and markets was taking on a more lasting character. For the next two years we were living in the captivity of high prices. It is difficult to invest in such environment, as there good opportunities are few and time passes infinitely slowly. The year 2015 perhaps represented a break point in this development. Even though a look at the main US and European indices suggests that it was essentially a year of stagnating prices, if one dives below the surface of the indices one sees large movements in individual share prices. Most share prices are lower today than a year earlier, and many of them very significantly so.

We can say practically nothing about future development of markets overall, but we believe that we can recognize good investment opportunities. Recently, there have been more of those than in the previous two years, and if we are lucky we will see even lower prices and more attractive opportunities. Then it will be only a matter of choosing the best ones.

On behalf of my partners and me, I would like to thank you for your backing and the support you continue to express in words and through new investments. We appreciate it very much.

Happy New Year.
Daniel Gladiš, January 2016