VLTAVA FUND

Dear shareholders,

Vltava Fund's NAV grew by 21.3% in 2013, and assets under management reached 1.5 billion CZK as of 31 December 2013.

Our largest equity positions at the start of 2014 were WH Smith, Berkshire Hathaway, Walmart, Teva Pharmaceutical and Catlin Group. Our portfolio is concentrated into investments which we consider to provide the best combination of returns and risk. Sufficiently attractive investment opportunities are quite 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 last year the net profits of our companies amounted to 9% of their market capitalisation (i.e. that is their earnings yield, which is the inverse of P/E). In our opinion, that is a high yield and does not correspond to the quality and prospects of these companies. This number particularly stands out in comparison to interest rates that linger close to zero. By our estimates, the fundamental valuation of our shares stands about one-fifth higher than their current prices. A fundamental valuation is not something static, however, but rather it is gradually developing. In the case of our portfolio, it is quite solidly growing. At the end of this year, it will be on the order of one-third higher than today's prices. This should create sufficiently strong upward pressure on the prices of our stocks to push them higher.

In the past five years, which means from the global financial crisis and at the same time from the change in our investment strategy, Vltava Fund's NAV has grown to nearly four times where it had been. More precisely, it has risen by 288%. While it is true that the past five years have been very good for equity investments, our results are nevertheless exceptional by worldwide standards. Our Fund has probably achieved the best results of all stock funds in the world during that period. (If you happen to find another fund which has had better results in the past five years than ours, please let me know so that we do not by chance brag of a supremacy which is not ours. To date, we have been unable to find such a fund.)

To quadruple your money and on top of that be the best in the world, it is necessary also to have a little luck. It is very unlikely that something like this will happen to us again. Be that as it may, we believe that we will be 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 on returns from the past five years.

In the next part of the Annual Report, you will find quarterly letters to stockholders from the past year. Taken together, they 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 2014

POLE, POLE

Dear shareholders,

In the first quarter of 2013, the Fund's NAV grew by 6.7%.

Several years ago when my brother and I climbed the slopes of Kilimanjaro, the local guides continuously repeated to us: "Pole, pole." In Swahili, it means something like: "Slowly, slowly". Flying in to Africa from almost zero elevation above sea level and immediately tackling a mountain almost 6,000 meters high requires a really slow pace. Those who followed this advice fared better than those who rushed upwards. We say "pole, pole" even when investing. But I mustn't get ahead of myself.

Five years later

The year 2008 is still so vivid in most investors' memories that one almost does not want to believe that we are already in the fifth year of the gradual recovery in markets and economies. We experienced a lot during that time. An unprecedented easing of monetary policy, massive printing of money and the historically lowest-ever interest rates, the associated inflation of the bond price bubble, a great surge and subsequent correction of gold prices, and strong growth in stock markets (even though only the American market has so far reached its historically highest level, and that is still without accounting for inflation). We also witnessed some smaller and some greater efforts to deal with growing state debts and the first actual bankruptcies (Greece, Cyprus). Even against the backdrop of what at first glance seems to be a very wild environment, attractive investments were, and still can be, found. Vltava Fund's NAV has increased by 242% since the beginning of 2009, and thus for each 1,000 crowns invested at that time, our investors have CZK 3420 today.

The economic and political development of the last five years suggests a lot about what may await us in future and what influence all of it can have on our investments. We will describe two highly probable and fundamental phenomena here: slow economic growth and financial repression.

Slow economic growth

Generally, we can expect much diminished economic growth relative to what we were accustomed to in the past. Through the last several decades, the global economy was largely driven by continuously mounting debt. Permanent and large state budget deficits in most large economies massively stimulated growth. The 2008 crisis had a sobering effect. It turned out that many countries had reached a ceiling beyond which the market would not be still willing to finance them, and others are quickly approaching that ceiling.

A breakthrough occurred and an effort (generally more verbal than factual) to economise came about. The accumulated debt suddenly became a brake on economic growth.

But it's not just about debt. There are other obstacles, too. These include a slowing in population growth, long-term decrease in the labour productivity growth rate, experiments such as the euro, rampant regulations and limitations on business, and various other artificially created inefficiencies.

When we put it all together, the probability is very high that economic growth in the following two decades will be much slower than in the decades before 2008. Countries that previously had a GDP growth trend of 3% will suddenly find themselves growing at only half that rate.

As investors, we are interested in what slow economic growth means for share prices. Paradoxically, this environment can be very favourable for shares. Many people believe that rapid economic growth is necessary for shares to appreciate more quickly. That, however, is not true. We do not as investors buy the economic growth of a country, but rather we buy the shares of individual companies. Their prices depend on their profits, or, to be more precise, the companies' profits per share.

Evidence clearly shows that companies in slower growing economies achieve faster profit growth per share. We can even call it a negative correlation in

the sense that the faster the economy grows, the slower a company's profits per share grow. How is this possible? Rapid economic growth requires greater investments from companies, and those are frequently financed by the issuance of new equity. Total profits may grow at a decent rate, but profits per share lag behind. Large investments also usually mean low free cash flow, and it is precisely in the magnitude of free cash flow that we see the main indicator of a company's value.

Companies' big investments based on expectations of sizable economic growth also produce a higher rate of error in the management's assumptions. For all of these reasons, we believe that **slower economic growth will bring a reduced need for investments, a lower risk of bad investments, higher profit growth per share and companies' greater free cash flow. This is certainly not a bad foundation for the growth in share prices.**

Financial repression

The world is changing. For a long time, it was true that state debt was a risk-free investment. I am not so sure that this is still true today… A month ago, it occurred to no one that bank deposits could be in danger. Nevertheless, depositors in Cyprus lost most of their deposits practically overnight. The confiscation of deposits came from the heads of EU politicians and was sanctioned by the International Monetary Fund. This is a very dangerous precedent. One would have to be very naive to believe politicians when they say this is an exceptional solution that will not be repeated.

The global debt crisis is a long-term problem the resolution of which will require the application of financial repression. This can take a variety of forms, some of which play out inconspicuously in the background. For example, negative real rates of return over the long term constitute financial repression of all owners of bank deposits. Others can come along gradually, for example in the form of state bankruptcies and forgiveness or restructuring of their debts (Greece). Others can be in the form of assets confiscation (bank deposits in Cyprus) or absurd taxation (75% income tax in France).

The investor's consideration thus moves to a new position. **The question of the new era is which asset is the most resistant to the various forms of financial repression?** Which asset will resist inflation relatively well? Which asset is the least likely to be taken away from me, cancelled, restructured or excessively taxed? Which asset is far from politicians' influence and experiments?

Our opinion is that, if possible, it is best to avoid various types of debt (i.e. bank deposits and bonds), due to their low yields and much higher risk of non-payment than is apparent today. **It is not good to be a creditor during a debt crisis. Debt crises are resolved by cancelling debts.**

A better way is to own shares of high-quality companies. Today, these companies are achieving high real returns and above all have the financial strength and stability that enables them to navigate through difficult economic times. It is clear that holding them will bring greater volatility in our returns than if we were to hold cash, for example, but the alternative (i.e. holding cash) will have much lower real returns, and all the more so the longer the period of financial repression endures.

Changes in our portfolio

We sold three positions. Sanofi, Seagate Technology and K'S Holdings.

Sanofi was our largest position. We started buying the shares in 2009 for approximately seven times earnings. Like a number of other pharmaceutical companies, Sanofi was also facing the so-called patent cliff and the patent protection of some of its large branded pharmaceuticals was nearing an end. For this reason, investors passed over Sanofi shares as uninteresting in the short term and ignored their long-term potential. We prefer long-term potential to chasing a fleeting trend, and we happily collected dividends of 4–5% per year while waiting for the market to awaken and value Sanofi's shares more appropriately. The market did wake up last year, and we collected a 70% gain on the sale. There are several titles similar to Sanofi in our portfolio, i.e. those with great long-term potential but that are currently overlooked by the market for some reason. We are happy to wait. Pole, pole.

In autumn, we bought **Seagate Technology** for the second time. The share price began almost immediately to rise swiftly, and we sold with a 32% gain in a relatively short time. Who knows, maybe we will take a gain on them for a third time.

K'S Holdings was our only Japanese position. Somehow we were not really convinced that it was a good choice, so we were glad to make use of the recent significant growth in the Japanese market and sold the shares with a 22% gain.

Exxon/Petrobras. For a long time, Brazil's Petrobras appeared to us to be a beautiful example of how to devalue an originally promising company when it gets into the hands of politicians. We finally decided to try and make something of this and opened a short position in Petrobras shares. To eliminate the risk that even share prices of bad companies such as Petrobras can rise during an unexpected increase of oil prices, we combined a short position in Petrobras with an equally large long position in Exxon. We closed both with a nice little profit this year. For us, such transactions are rather exceptional and we do not seek them systematically. On the other hand, they do not require any capital and help us to continue developing as investors.

Pole, Pole.

We have had a good start to the year. We could have earned more if we had been a little more aggressive. But that is not our wish. We prefer to be more cautious, holding plenty of cash and patiently awaiting attractive opportunities. There is no rush. Pole, pole.

Daniel Gladiš, April 2013

VLTAVA FUND

GODZILLA (ゴジラ)

Dear shareholders,

In the second quarter of 2013, the Fund's NAV grew by 1.4%.

Land of the Rising Sun (and dark storm clouds)

Let's take a trip to Japan. Why precisely there? Well, that will become clear in a moment. To many people, Japan may seem distant and irrelevant from an investment perspective. However, just the opposite is true. Japan is a big economy with expansive financial markets and is home to one of the main reserve currencies. It is contending with immense financial problems, and its efforts to resolve these will impact the entire world.

Here is a brief summary of the state of Japanese finances: Debt-to-GDP is 240%, which is twice that of Greece, Italy and Spain and five times the Czech Republic's debt. The annual budget deficit is 10% of GDP – three times larger than the Czech deficit. Budget outlays are twice as high as revenues, so the Japanese must borrow one yen out of every two yen of spending. In comparison with Japan, the entire western world looks like a shining example of commendable responsibility.

Even with the extremely low Japanese bond rates that now range around 0.85% per annum for 10-year securities, interest expenditures gobble up one-quarter of state budget revenues. Should interest rates rise to around 3%, interest costs would consume all budget revenues. There is not much to envy in the Japanese situation.

The Japanese need to cut the budget deficit without plunging more deeply into recession while also stabilising and progressively decreasing the overall debt and maintaining very low interest rates. I don't know if such a thing is possible. Probably not. Theoretically, however, there are two courses from which to choose.

The first is rapid economic growth. I do not perceive this as very probable. If we are to search for a period of surging growth in the Japanese economy, we need to go back more than 20 years. Over the long term, Japan has been slowed by its large debt, much inefficiency in the corporate sphere and tax system, as well as its own demographics.

In Japan, women give birth to an average of 1.5 children. To maintain the current population size, a ratio of approximately 2.1 is needed. Japan last had such a fertility rate about 40 years ago. To put these numbers into perspective, **with its current fertility rate, each generation is 30% smaller than the previous one**. While in recent years Japanese GDP per capita has been growing faster than in the United States, the economy as a whole is growing much more slowly due to differences in demographic development. While the number of Americans is on the rise, the Japanese are diminishing in number.

It is not very probable that real economic growth will resolve Japanese debt problems. The Japanese economy is unable to grow even when it has a 10% budget deficit. If real growth is not an option, then there is still nominal growth, which is to say via inflation. A marked devaluation of the currency offers the easiest path. This will have a pro-inflation effect, and, in Japan's export-focused economy, even a pro-growth effect. At the same time, Japan needs to maintain its low bond yields.

Having thusly defined the problem, the Japanese have initiated massive so-called "quantitative easing" (i.e. printing money). The Bank of Japan began buying state bonds en masse with the newly created money. The market was flooded with yen, which led to its significant loss in value vis-ŕ-vis other currencies while succeeding to maintain low interest rates.

The Japanese unleashed this operation on a breath-taking scale. Relative to the size of their economy, they are buying three times as fast as does the U.S. Federal Reserve. If there is any speed that can be considered crazy, this is it. And because Japan is a part – in fact a relatively large part – of the global markets, its new gigantic money-printing machine has rocked the whole world. **Japan's problem is also our problem**.

Godzilla's roar

The Japanese have awoken Godzilla, and its roar can be heard around the globe. See for yourself. Since November, when the Japanese took up their task in earnest, the yen has weakened sharply. The Japanese stock market spiked up by 75% and then had a 20% correction. Shares on the emerging markets have had their worst year in a long time, and the same can be said of their currencies. Bonds have been markedly dropping wherever one looks, and overall market volatility has risen substantially. Gold fell by almost a third, and in spring it took of its deepest one-day price dives of all time.

Imagine the entire financial world as a balloon being pumped with air – that air being newly printed money. When its flow and pressure get too strong, the balloon starts to leak at the weakest spots. Those are where large price fluctuations occur. The Japanese have already shaken the unstable global financial system and caused huge waves. **Great fluctuations in exchange rates and interest rates are primary reasons for big changes in global asset re-allocations, to which we are now witnesses.**

Changes in our portfolio

Based on the previous paragraphs, it might appear paradoxical that the past quarter was the first in the Fund's history in which we did not buy any new positions or sell out of any. In considering any new investment, we always compare it with what we already have in our portfolio, and also with the option of doing nothing. During the past three months, we mostly found it better not to do anything. We were satisfied with all of our positions, with their gains and the development of their businesses. In June, when share prices started to fluctuate more in response to the Fed's unexpected rhetoric and the Chinese credit crisis, we became a bit more active and made some additions to our existing positions.

We do not suffer from rhinophobia, which is a fear of cash and the urge quickly to do something with it. We know that good opportunities always will come along. We have enough cash, and if they come tomorrow, we are ready. If not, we will patiently wait for those opportunities.

A lesson from Japanese development

What's happening in Japan is really big. No one, including the Japanese themselves, has a clue as to how it will all turn out. We are navigating unexplored waters without the possibility even to rely on historical precedent. One thing does seem obvious, however. **In the absence of greater economic growth, the preferred solutions to financial problems will be to print money, devalue currencies, maintain negative real interest rates, and erase debts through inflation.** Eventually, all states having their own currencies will go down this path.

What does it mean for investments?

1. Cash: This is useful as a reserve asset, but it will continue significantly to lose value over the long term.

2. Bonds: Their yields in no case provide any real compensation for the risks of inflation and default. They effectively represent almost certain loss.

3. Gold: Warren Buffett says it is good for almost nothing and does not multiply. Its historical yields are zero in real terms.

4. Productive assets (equity shares in companies): In a recent interview with a CNBC journalist, Warren Buffett recently said that equities are priced appropriately, "but you'll see numbers a lot higher than this in your lifetime."

This cannot be said about any asset classes other than equity. Therefore, shares should occupy the fundamental place in most investors' considerations and in their portfolios.

Wishing you a nice summer,
Daniel Gladiš, July 2013

DNA OF EQUITY INVESTORS

Dear shareholders,

In the third quarter of 2013, the Fund's NAV increased by 1.9%. Growth since the start of the year is 10.2%.

Having things under one's control

Through the 20 years of our professional careers we have met a great many investors and potential investors. Over time, we came to recognise that they can be divided into two basic groups: those who are equity investors and those who are not equity investors.

Those who are not equity investors comprise a type of people who like having things under their own control. They are happy when they can touch their investments, and their thinking is quite concrete. There is basically no point in offering equity investments to such people. Even if they let themselves be persuaded, it usually ends with disappointment for both sides. By contrast, typical equity investors are people who do not mind that their investments are not under their direct control, or the fact that they cannot touch them, and they are accustomed to thinking about such abstractions as compound interest. They also know what they want, and there is no need to twist their arms in order to provide it to them.

The demand to have one's investments at all times under one's own control is the place at which the DNA of equity investors differs most from that of those who are not equity investors. Three conditions must be met for the requirement to have personal control over one's investment to be legitimate. First, the investor must be able to build the business oneself better than others can do so. Second, the investor must be able to manage it better than others. And third, the investor must be able to allocate the earned capital well. In our opinion, only very few people have such abilities.

Let us consider two companies in our portfolio as examples, Berkshire Hathaway and Wal-Mart. Now let us answer the aforementioned questions. Are we able to build similar businesses? No. Are we able to manage such businesses better than are the current managements? No. Are we able to allocate capital better than their current managements? No. **At least 99.9% of investors must answer three times no.** There is not the slightest doubt about that. So what is wrong with owning a minority share without the possibility to control a company when that company is unique, non--replicable, and governed by excellent management for the benefit of the shareholders?

If a genius (Warren Buffett) manages a company that is unique (Berkshire Hathaway) and moreover for the benefit of shareholders, then the DNA of equity investors says YES! The requirement to be in control in this case would be foolish. And that is not the whole story. Equity markets, due to their manic-depressive nature, sometimes offer shares in these companies for prices that would not be even considered in private transactions. Then we say twice yes.

What you can control

Investment managers must always realise which things can be controlled and which cannot, and where it makes sense to strive for control. **Three things can be controlled: the investment philosophy, the investment process, and the composition of clients.**

Investment philosophy. You would be surprised how many professional investors are unable to formulate their investment philosophies. This would be equivalent to the coach of FC Barcelona instructing his players: "Go to the pitch and play it as it comes, just go with your gut." I have never been in the team's locker room, but I am pretty sure that is not the way they do it. Even the fictitious football coach Pepík Hnátek had his strategy to "kick it long past the defence and hit the goal". There must be an investment philosophy. It can adjust over time with the development of its authors, and particularly as they learn from their mistakes, but it must be clearly formulated.

Our investment philosophy is simple.

1. We believe that equities make the best long-term investments.

2. The basis of equity investing is regular cash flow from the companies to their shareholders in the forms of dividends and buybacks of their own shares.

3. In good companies managed by high-quality management, this flow has a strong tendency to grow.

4. Share prices follow this growth over the long term.

5. Because many people view the equity market like a casino, we often can buy shares at prices markedly below their fundamental values.

Investment process. Our investment process focuses mainly on points 3 and 4 of our investment philosophy: We seek out good companies run by high-quality management teams with a strong growth tendency, and then we estimate the values of those companies. We endeavour to reach an understanding as to what share prices would make these companies attractive investments.

Investing is not a natural science, and that means there are no laws. There are only certain principles. The investor's subjective opinion will always be a crucial part of the investment process. There is no objective definition of what is a good company or high-quality management. Even the company's value does not objectively exist. It will always be in large measure an opinion based on one's own experience and ideas.

Investments should not be evaluated according to whether they made or lost money, but according to whether the investment process upon the basis of which they had been selected was correct or not. This may sound a little odd, because, after all, you are interested mostly in results. We are, too, but we think that good returns can only be achieved on the basis of a correct investment process.

If you were to pick a stock at random and made money on it, you scarcely could assert that that had been a proper investment process. It was an accident. On the other hand, sometimes even investments acquired "correctly" according to a quality process can lose money. Of course, if most investments were to yield poor results, then probably the investment process is not correct. Nevertheless, the alpha and omega of the investment managers' work is the effort to create and perfect an investment process. An investment process is something you can control.

Composition of clients. Having a big fund has never been our main goal. Our priority is to do work that we enjoy and to do it for pleasant people who try to understand what we do and who think in a similar way. We have full control over the composition of our clients. We see our investors as partners. We choose (or refuse) them on this basis while endeavouring to build long-term relationships. We strive to explain what we do, as well as why and how we do it. That is also why we write these commentaries.

We want to have a stable, long-term coterie of investors founded on trust in what we do. Sometimes we feel like we succeed in this very well, and at other times we may feel less so. The truth is that 98% of our shareholders at the end of each year had been our shareholders also at the start of the year. This makes us very happy.

Changes in the portfolio

Over the past three months, we mainly added to existing positions in our portfolio. We have two new positions. The first is a British company operating in

a sector where we have not invested before. We think it is a very attractive opportunity with a double-digit expected annual yield for a number of years into the future. Nevertheless, because it is new for us, we are building the position gradually.

The second company is American, and we have been following it for many years. We almost bought it last autumn. We had our finger on the trigger, and all we had to do was to pull. The shares were fantastically cheap, but we were lacking a little in courage. Today's price is somewhat higher, but it still provides a very attractive opportunity.

We sold AIG. AIG was one of the synonyms for collapse of the financial sector five years ago. The government had to spend an incredible USD 180 billion to rescue it. Then something unexpected happened. Not only did AIG survive, but it paid the entire USD 180 billion back to the government. The repayment process was completed last year. At the same time, the government sold all of its shares, a significant part of which AIG itself bought back. AIG sold off some of its marginal businesses, dealt with most of the bad investments from the pre-crisis period, and under new management began to rise again. For many investors, however, AIG still bore the stigma of 2008, and professional managers did not want to be seen having it in their portfolios. The market simply had not taken into consideration the standing and quality of the "new AIG". This allowed us to buy shares for almost half of their book value. In summer, we sold them with a 33% gain, because we felt we had already made the easy money, and we did not view the further expected returns as very attractive.

AIG was a rather atypical investment for us. We held it for a very short time – only about 9 months. It represented more an effort to exploit a manifestly transitory error in the market's valuation of its shares. We are not opposed to engaging in such opportunistic transactions as a complement to our core investments.

Current state of equity markets

This year, the US market is repeatedly pushing to new historic highs. Is this a good or a bad thing? Well, we do not regard the mere fact that the market is at a historic high as big news. Over the past 100 years, the US market reached new highs more than 1,000 times. And essentially we might say that we invest in equities because we expect the market to go higher and higher over the long term, just as it has in the past.

The level of the market must be compared to the level of profits in the companies. This, too, is at a historic high, so it is quite logical that the market behaves accordingly. If we follow this line of reasoning still further, we must ask whether the current level of corporate profitability is sustainable. This is not so unambiguous, as the profit margins of US companies are also at historically high levels.

In such case, we should expect to see so-called "regression to the mean," which is to say that profit margins should be expected to trend somewhat downward to their long-term average. A narrowing of margins does not automatically mean a decrease in profits, however. Companies' profits should be expected to decline relative to the size of GDP, but, as GDP is growing nominally, it is not necessary that nominal profits of companies must diminish as well. Moreover, this process of regression to the mean margins can sometimes occur very gradually and may extend over many years.

We also must not forget that the equity market is a market of individual titles. And practically always there are concurrently titles that are exceptionally expensive and others that are exceptionally cheap. The US market is today in a peculiar state. On the one hand, there are lots of absurdly overpriced titles.

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One could buy shares of companies without profits (sometimes even almost without sales) or shares of over-indebted companies of inferior quality. These are frequently stocks which investors feel embody some sort of "story", and they forget the fact that the value of each investment depends on future cash flow.

On the other hand, there can be found a number of companies with no "sexy story" but which offer profits, quality, financial strength, and, above all, a good share price. The situation is somewhat similar to that in the markets in 1999 and 2007. In 1999, while the so-called dotcom bubble was inflating, entire sectors of shares were absurdly overpriced. Everything related to the internet, telecoms, technology – which is to say the "story" of the time – was crazily expensive. In 2007, the "story" was commodity and financial companies. In such periods, investors completely disregarded a large part of the market where many attractive opportunities could be found among strong and established companies. In the following years, these were the companies that provided clever investors with handy returns, while a number of those companies through which speculators chased the "story" do not even exist anymore.

We see the situation somewhat similarly today, and I probably need not mention in which market segments attractive investments can be found. The contrast between low-priced and expensive market segments is really clear-cut today. **We are conservatively holding high-quality and low-cost shares, even with full knowledge that for a certain time (and especially as the market climbs further) it may seem that our results are only average.** Carefully forward.

Daniel Gladiš, October 2013

VLTAVA FUND

8-1-1

Dear shareholders,

The Fund's NAV grew by 10.0% in the fourth quarter of 2013. Thus, the returns to Vltava Fund SICAV reached 21.3% for the year 2013 as a whole.

A look back

Inasmuch as we have our first 10 calendar years behind us, now is a good time for a brief retrospective. Our score from the first decade is 8-1-1. Eight times a positive result (including the unique year 2009), once a negative year within normal bounds (2011) and once an abysmal year (2008). We refer to 2008 and 2009 as the "Halley's Comet Years", because we believe that we will not live to see such bad or such good years again.

Our investment strategy is not the same today as it was 10 years ago. It is developing – and we believe improving – step by step, and we ourselves are eager to see how it will evolve going forward. Our greatest mistake in the Fund's earliest years – and which backfired on us in 2008 – was that we were trying too hard to be too clever. In short, we overcomplicated things. We attempted to make too much money too fast using too large a combination of short and long positions. We gradually came to realise that this is unnecessary.

We started out like the Earl of Sandwich, inventing the sandwich in the short story by Woody Allen. His first completed work – a slice of bread, a slice of bread on top of that, and a slice of turkey on top of both – failed miserably. His second attempt (two slices of turkey with a slice of bread on top of them) was not successful either. Not even the two following experiments (three slices of turkey and three slices of bread) caught on. Crushed by his failures, the Earl of Sandwich noted in his diary: "Simplify, simplify!"

We wrote the same into our diary. **Since the start of 2009, our investment strategy has been much simpler. Perhaps paradoxically, this has not been to the detriment of returns. The Fund's NAV increased almost four times over between 2009 and 2013.** This puts our standing quite high in an imaginary worldwide ranking – possibly even at the very top, as we have yet to find a fund that would have higher returns for the given period. In any case, it appears that our portfolio can do just fine without the dose of steroids with which we formerly were doping it.

The facts that not only can things be done in a simpler way but also that we will be better off for so doing might be termed our 'great stroke of enlightenment'. Had we known 10 years ago what we know now, we could have avoided the great plunge of 2008. Unfortunately, that is not the way things work. Everything follows its own course, even knowledge. We might think today that we are much better investors than we were 10 years ago, but it is quite possible that after 10 more years we will critically evaluate the ideas we adhere to today and reproach ourselves for today's mistakes.

This is the most intriguing thing about investing – that one can continuously develop and improve. Each error can be become a source of knowledge and further advance our understanding. I even think that if our experience from 2008 had not been so bad and intensive, we might have atrophied and be worse off for it today. Who knows how it all works?

Now, enough of ruminations upon the past and let us look into the future…

A look forward

As always, the only thing we can say with reasonable certainty about the future is that it will bring a lot of things that nobody expects. We have not the slightest idea as to the direction in which the world economy and financial markets will develop. We are in no way disadvantaged by that, however. Inasmuch as we have not heard of anyone who would be able to predict future development with sufficient probability, our own inability in this regard does not worry us in the least. **On the contrary, the fact that we recognise our own inability (and the impossibility generally) of reliably predicting the macro development, market movements or even investor confidence is a fundamental source of our investment strategy.**

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We endeavour to focus on specific, individual companies, upon evaluating their competitive advantages and especially their sustainability, their financial strength and the activities of their managements with a view to creating value for shareholders. The macroeconomic circumstances usually play no role in these considerations. And instead of prognosticating upon the movements in share prices we emphasise the importance of low investment price. This is the best protection from permanent loss of capital.

The future was, is and always will be uncertain. This is nothing new. Indeed, one of my earlier letters to shareholders was called "On the Beauty of Uncertainty". Uncertainty is a good thing for the investor. The greater is the uncertainty, the better are the investment opportunities. Investors may be more aware of uncertainty today, but uncertainty in and of itself does not change much.

We can imagine our future returns as the product of future development and our portfolio. While we can say but little about future development (let alone think about having any control over it), we fully control what will be the composition of our portfolio. And that is where we direct all of our efforts. We try to invest so that our results will be good under almost any future development scenario.

Long-term threat

As we have written in the past, inflation is the investor's greatest enemy (and at the same time his or her motivation). If inflation were zero, or even negative, it would not be necessary to invest. Money would not lose its value. Unfortunately, inflation is almost invariable positive and this fact compels anyone who has money to invest. We have been living recently in an environment of very low inflation (if we believe the official numbers), and no indications of rising inflationary pressure are on the horizon.

If inflation remains low over the long term (which is a variant that can occur), then our portfolio will fare well and provide respectably positive real returns. However, a diametrically opposing variant is also possible. There is a chance for long-term higher inflation that is accompanied by much higher interest rates. We cannot say which of these two scenarios is the more probable, but it is clear that the scenario of higher inflation and higher interest rates is the more dangerous. There are two reasons why that is true.

First, higher inflation erodes the value of money much more quickly. And second, higher interest rates weigh upon the gains accruing to all asset classes. This would affect bonds, equities, real estate and gold. The interest rate is perhaps the most important quantity in investing. It is used as a gauge for valuing individual investments. Currently, interest rates are being deformed by central banks and skewed downward from their equilibrium values. Their more pronounced rise would affect literally all markets. Bonds would be impacted more notably than equities, and not all equities would be hit to the same extent, but nothing would be spared.

We endeavour to choose our investments so that they provide the best possible compensation in the event of long-term higher inflation. For example, we own companies that will directly profit from higher interest rates, companies with low capital expenditures, and companies which are positioned to be able to shift rising costs to their customers. Such companies should be able to fare relatively well in a higher inflation environment, both in absolute terms and relative to others. We are working to build into the portfolio protection against high inflation, so long as such equity titles are low-priced. Perhaps we are starting too early, and maybe things will turn out such that this will not have been necessary. We are aware of such possibilities, but we nevertheless believe that this is the right way to go. It is better to be insured more than necessary than not at all.

Changes in the portfolio

We did not sell any positions in the past quarter and opened two new ones. In both cases, these titles are among the most valuable of global brands, and the description from the previous paragraph fits them

precisely. We intend to gradually build our exposures to both companies, and we expect that they will bring us attractive returns with very low risks for many years to come.

Through the whole of 2013, we opened 5 new positions and sold out 4 older ones. In total, we have 24 various titles in our portfolio. Approximately 80% of the portfolio's composition did not change over the year. Only the sizes of individual positions changed. We view ourselves as long-term investors, and our investment considerations look to horizons of several years. The stability of the portfolio's composition corresponds to this view and these considerations.

Up or down?

The question we get asked most frequently is whether the markets will go up or down. When we sincerely answer that we do not have the faintest idea, some people look at us with puzzlement. What sort of amateur ignoramuses are these people, after all? Others, meanwhile, wink at us as if to acknowledge that we naturally would not wish to reveal to others where lies the Holy Grail.

But we truly do not know – and do not even seek – the answer to that question. Instead, we search out low-priced titles and good investments. Some markets are today more expensive while others are less so. But even on the more pricey markets there are good investment opportunities. A person must respect the overall valuations of entire markets and cannot ignore these realities. If a market seems expensive, there are still several possibilities for how to deal with it.

In some cases, one can take a long-term view. While this is often used as an alibi for instances of not very successful investments, sometimes it can be a very rational approach. One can then focus on individual special cases, whether the particular situation concerns the company itself or an exceptional personality who is leading it. Alternatively, one can hold cash.

This combination also describes our approach. We have certain companies in our portfolio whose extraordinary quality, strength, stability and predictable development practically assure us that in future the prices of their equity will stand much higher than today and with minimal risk to boot. We also have companies in our portfolio which are led by people with exceptional abilities to create value for shareholders. Then, too, we own shares in companies which, because they are presently overlooked and underappreciated by the market, have very low share prices even though they are faring very well. Moreover, we also have a lot of cash.

When markets move up, we will be better off on paper, but later returns will be lower for it. If the market turns down now, we will be worse off for a while, but we will make that much more money later. In either case, it is probable that over time our equities will be much more valuable than today. **How much more they will be worth will not be decided by whether the market will now move up or down but by how well we are able to select the individual investments.**

We thank you for the support you have given us in the past year, and, for many of you, through the entire 10 years, and we wish you all the best in 2014.

Daniel Gladiš, January 2014