



RISK. ANYBODY INTERESTED AT ALL?

In the nearly 30 years of my professional career, I have participated in a great many investment debates at various levels, in various forums, both private and public, professional and completely among laypeople, and in a number of different countries. The debate often comes around to returns, be these historical or expected. I do not recall, however, anyone ever asking the following question: "How much risk do you have in your portfolio?"

As if the only thing that matters was returns, and the risk that has to be undertaken to achieve those returns was irrelevant. As if nobody cared about the risk. In part, at least, this is understandable because returns are specific, easily measurable, and bring direct benefit whereas risk is an abstract concept, each person defines it differently, and what's more it is not measurable – not even ex post. Nevertheless, it does not pay to ignore risk.

Imagine you drive to work every day. It is a 40 km trip and it takes you 30 minutes at an average speed of 80 kilometres an hour. For your colleague, the same journey takes just 20 minutes because he drives half again faster than you do. Every day, he boasts about how much better driver he is until one day he does not make it to work at all. His faster journeys to work were undertaken at the cost of much greater risk. Various estimates say that from 80 km/hour onwards, every 15 km/hour increase in speed doubles the risk of serious accident. Most drivers probably do not know these figures and do not much take them into account.

In investing, it is similar. We always keep in mind the quote from the father of value investing, Benjamin Graham: "Investing isn't about beating others at their game. It's about controlling yourself at your own game." In the driving analogy, this means reaching the end point every time. In the investment analogy, it means not putting money at risk of permanent loss. We are a bit obsessed with this goal (and maybe this is a mistake, but we will get to that later). Whenever we make an investment, our goal is to not lose money on it. We believe that by avoiding larger and more frequent losses, the rest of the portfolio will provide solid returns.

If I am counting correctly, over the 12+ years of our current investment strategy, we have bought 80 various stocks, 58 of which have since been sold. We made money in 50 cases, and in 8 cases we lost money. (As for the 22 positions we currently hold, it looks so far like we will make money on all of them.) So we can say that we are making money on approximately 9 stocks out of 10. This is not a 100% result but it is not far from it, especially when we take into account that in absolute terms these losses were rather minor.

Our strategy is not carved in stone

There are two reasons why the number of loss-making investments is low. First, we strictly insist that a stock must be cheap and that there must be a large margin of safety, which refers to the difference between the stock's price and its value. Price is always an important component of risk for us, and low price reduces this risk significantly.



Second, we strive to learn from our own mistakes. We constantly endeavour to question how we are investing. We observe which things work and which do not and try to differentiate between what happens by chance and what role our own decision-making plays. And so our investment strategy evolves over time. To be specific, I will give a few examples. In looking at our current portfolio, probably only few would think about these things because they are mostly things that are not in the portfolio. Not by accident, but by design. Actually, for a moment I am going to talk about what we do not own. Investing can also be thought of as negative selection, in fact, and a good investor should be able to say NO to maybe 99% of investment ideas.

We avoid some regions

You may remember that in earlier years we had several investments in China and in other countries of Southeast Asia. We devoted several years of effort into analysing this region and we were looking for good investments there. In the end, we came to a conclusion that it would be better to avoid this region altogether. Investing is a matter of probabilities and the probability that we will succeed in searching for good investments here is lower than it is in developed markets for a number of reasons. Generally speaking, it is not worth taking risks that we can avoid simply by going elsewhere. Therefore, over the past ten years, the focal point of the Fund's portfolio has been in developed markets.

We avoid some sectors

In earlier years, and especially in the times of rapidly rising commodity prices during the second half of the past decade, we also devoted several years of work into analyses of

the mining sector. Oil, gas, copper and nickel in particular. We had an analysis for virtually every major mining project in the world. As a result, we became convinced that, due to their general characteristics, these sectors are unsuitable and too risky for long-term investing although from time to time they can provide investors with attractive returns due to their strong cyclical nature. Since that time, we have avoided them.

We avoid companies where we doubt that management is running them for the benefit of shareholders

In the early days of the Fund, we had three investment cases (in Norway, France and China) where we had major objections to the way the managements were running the companies. At that time, we tried to fight for the interests of shareholders. We had meetings with management, we were very active in conference calls with company executives, and we even wrote letters to the boards of directors. Even though in hindsight it turned out that we were right and in all cases management caused great damage by its actions, we were unable to change anything. The only thing left to do was to sell the shares.

Therefore, it seems to us a better idea to invest from the very beginning into companies where management has the same interests as the shareholders and confirms this by its actions. Today, approximately half of Vltava Fund's portfolio consists in shares of companies that are managed or largely owned by their founders or their descendants.

We avoid companies with large debt

If there is one thing that can quickly lay a company low, that is its massive debt. We give



such companies a wide berth. We prefer firms with strong balance sheets, little debt, or even net cash and that do not rely on the capital market's willingness to finance them. On the contrary, most of the firms we own return excess capital to shareholders in the forms of dividends and repurchases of their own shares.

It is safe to say that the companies we own will do well under almost any circumstances, including a deep recession, and may even emerge stronger from such an environment. The severe pandemic recession we have just experienced has confirmed this assumption of ours. It is virtually impossible to estimate probabilities of relatively rare events such as was this pandemic. What is possible, however, is to estimate the resilience of individual companies to such events. That is what we are trying to focus on.

We avoid companies without proven and profitable business models

Today, we live in a time of so-called non-profit prosperity, when stocks often do well that are issued by companies that not only are not profitable and never have been profitable but often may not even have a clue how ever to become profitable. We are not interested in such businesses. We are interested in companies that are consistently and in the long term highly profitable and have business models that have been tested by a number of crises. Perhaps this is due to our age, but we stubbornly, and it may seem even old-fashionedly, are of the opinion that profit is the reason for doing business. We strictly demand profitability from our companies. Valuing shares of such companies does not then require that one make heroic assumptions

about the future, which is itself another often overlooked source of risk.

We are not trying to compete with the neighbourhood or the indices

Investing is not a race and its goal is not to beat the competition or the indices. Indeed, such competition often tempts investors to take excessive risk at times when it would be rather more prudent to hold back. If a stock index is rising too fast, then the only way to beat it is often to buy more and more of the stocks that constitute its peak at higher and higher prices. At some point, the risk associated with this approach is so great that it loses any semblance of sense. This is one of the reasons why it is not our main priority continuously to compete with an index.

If you have been following our returns for some time, then you know that over the 12.5 years of our current investment strategy, our return is significantly greater than the return of the global stock markets (Vltava Fund 392% vs. MSCI World Index 236%). You surely will also have noticed that in some periods we lag behind the index. These are usually times when in our opinion it is better to put risk first and returns only second. Something similar can be expected also in future.

The goal of investing, as we see it, is to increase the real value of money over the long term while taking on an acceptable level of risk. One memory I have from the 1990s relates to this point. I think it is very relevant to today's market situation, which itself quite reminds me of the second half of the 1990s.



How did it look like in the nineties?

Sometimes between 1996 and 1998, when I still co-owned Atlantic FT and was a broker by profession, I made around 200 visits to my clients, mainly in the US and UK. These were mainly large mutual funds and hedge funds. Some of these investors were already legendary at that time, and I literally devoured their stories. I could listen at first-hand how these investors invested around the world and how they were thinking about investments.

To make things simple, all these investors could be divided into two groups. In the first group, there were the rather younger and more aggressive ones who focused their portfolios on stocks of the IT and telecom mania then in full swing. Even back then, these were companies with mostly no profits, often with almost no revenues, but with extremely high stock prices. Anything else they considered a relic and uninteresting. Investors who did not share their view were labelled as dinosaurs who did not understand the modern world (this included, of course, Warren Buffett, who, immune to the singing of the dot.com sirens, was at that time preparing one of the most important transactions in Berkshire Hathaway's history: the acquisition of General Re).

The second group was made up of investors who, like us today, cared about quality, safety, low share prices, and companies' profitability. There would still be nothing special about this division. People commonly differ in their views. Interesting, however, is what happened next.

For several years it seemed that the first group would dominate the market. It had high returns and investors flocked to them. The second group had lower returns and investors turned

their backs on them. They thought that these portfolio managers did not know what they were doing. Nevertheless, they knew very well. Then came the spring of 2000, the Nasdaq Index with its large representation of IT and telecom companies turned downward until it eventually fell by almost 80%. Shares of the so-called old economy on the other hand did very well. Investors in the first group lost almost all their money and portfolio managers from this group often lost their jobs literally overnight. Who knows where they are now? A great many of the companies that were at that time making up their portfolios are also long gone. On the other hand, investors from the second group were very satisfied and portfolio managers from this group in many cases continue successfully in their work to this day.

This completely different approach to risk in the two groups was striking at that time, and I was very intrigued even though I did not yet know how it would all turn out. It impresses me even to this day. Portfolios of the two groups had completely different levels of risk. Today, there is a somewhat similar situation in the markets as during the second half of the 1990s. On the one hand, there are a number of very expensive stocks with unclear futures but they are nevertheless very popular and many believe that owning anything other than these stocks makes no sense. On the other hand, there are many overlooked yet reasonably priced stocks of companies that are doing very well in their businesses. The dimensions of risk associated with investing into these two groups of stocks also are diametrically opposed. Perhaps it is needless to say so, but we are fully invested into the second group. History suggests that this is the better and, more importantly, the safer route.



Are we not making a mistake?

Our risk aversion is probably clear. Nevertheless, there exists a logical objection as to whether it is not too great and therefore ultimately harmful. After all, it is not the aim of investing to eliminate as much risk as possible. That would translate into lower returns. Perhaps it would be better to be much more aggressive and target much higher returns in individual investments even at the cost of more frequent large losses. We are aware of this. But going back to the driving analogy, the first priority for us is always to reach the desired end point.

If we put aside our institutional investors (mutual funds, insurance companies, corporations, churches, etc.), the average age of our individual shareholder is 55. Therefore, we naturally do not encounter any encouragement from you, our shareholders, to take more risks. Risk is a complicated thing, and a very subjective thing. Our view of what is and is not risky changes over time, and it will probably continue to do so as we gain more experience. However, we are unlikely to change our conservative approach in future. It would be easy to jump into various trends and fashions and try to make money faster regardless of price levels. It would surely work for a while, but the associated risk would be too great and eventually it would impact negatively on returns. After all, our own experience from 2008 confirms this.

Back before the pandemic, I participated in a certain international investment conference. One of the participants opened a debate on whether a portfolio manager should buy popular stocks even in case he or she does not believe in them in order to increase the inflow

of assets into the fund or whether one should stick to a strategy one believes in even at the cost of losing some assets. Opinions varied and tended to reflect participants' priorities. If I may speak for myself, if I had to choose, I would rather lose some of the investors who feel that we are making money too slowly for some period of time than to lose their money by taking excessive risk and chasing after returns. In other words, I would rather, in the extreme, lose my career as a professional investor than put the money entrusted to us at too much risk. This is an attitude I have always admired in the greatest and most successful investors and I consider it to be the only defensible one.

Changes in the portfolio

During the past quarter, no new stock appeared in the Vltava Fund portfolio and we also did not part with any. We only increased our positions in NVR, CVS and in TGP Class A preferred shares. There was no serious reason for greater trading activity. This does not mean, however, that we were passive. We do not measure our activity by number of transactions. Most of our time and effort is spent on analysing individual companies and preparing, expanding, and updating a sort of stock "shopping list" that we can turn to at any time when the price/value ratio of any stock on that list is attractive.

Sometimes this activity brings tangible benefits immediately, other times only after many years. For instance, our returns over the past year are not solely a result of our work in the course of that year but the result of cumulative activity going back many years and culminating in the current composition of our portfolio.

If you think of the spring last year and the arrival of the pandemic, you will surely



remember that the markets fell very quickly and sharply but also that they turned 180 degrees overnight and started to rise rapidly. So the opportunity to buy shares at really super attractive prices was very short-lived, and anyone who was at that point just starting to look around for good investment opportunities missed the best prices. Relatively little can be said reliably about the future development of stock markets but one thing is very likely. They will be volatile and large movements of either whole markets or individual stock prices will bring attractive investment opportunities from time to time. We think we will be ready to react quickly to these and to take advantage of the opportunities, perhaps because of the analytical work we have done in this otherwise relatively quiet quarter. We nevertheless cannot know, of course, which stocks this will involve.

The letter to shareholders I wrote six months ago was entitled *Inflation*. I described in it the reasons why we were likely to face a period of higher inflation. We are already in that period today. Prices are rising everywhere one looks. Yesterday, by coincidence, I had lunch with the owner of a large construction company, and I was astonished when he described to me how prices of building materials and construction work had soared. Numbers like 40% or 80% were mentioned – and we were talking about year-on-year changes.

Central bankers keep repeating their mantra that inflation is only temporary. In purely technical terms, they are right because everything in life is temporary. What matters, however, is the course of things between now and the end of the temporary. This is doubly true for inflation. If the current rise in inflation ceases over the summer, turns out to be a one-

time matter, and then it returns to the dreamed-of 2%, that does not mean that prices will fall back. Albeit more slowly, they will instead rise from a higher base. The effects of inflation are cumulative in character.

The latest known annual inflation rate in the US is 5%. Because short-term interest rates and rates on most deposits are close to zero, this means that deposit holders have lost 5% of their real value over the past year. That is a huge amount of money, and it is lost forever. It is actually a form of very high, hidden taxation. What makes the current inflation much worse than it might seem to be are precisely the historically record high (or perhaps rather deep) negative real interest rates. If interest rates were, say, 7% at 5% inflation, then it would be easier to defend against it. But we are miles away from such a world. In fact, negative real interest rates are now common throughout the developed world. This is where the development has brought us.

So whether high inflation is just a matter of this summer or rather a medium-term phenomenon, the environment in which we have been living and investing already for some time, that is to say an environment of significantly negative real interest rates, will be here on a long-term basis and the scissors between inflation and nominal rates will tend to open up. We have been saying this for a number of years now and, unfortunately, developments are proving us right. As it shows again and again, inflation is the investor's main enemy and at the same time the main motivation to invest.

Daniel Gladiš, June 2021



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