SIZE MATTERS

When we get together with you from time to time in various meetings and go through our portfolio, we often get asked how we determine the size of each position. I want to address this topic in today's letter to shareholders. It is one thing to select individual titles, but it is another to determine how much weight each of those individually receives in the portfolio. This is a matter that is rather rarely discussed in general, but it is very important. It is also very subjective. Weights matter because they have a big impact on the portfolio's overall return. Each stock in the portfolio contributes to its total return by a number that is the product of the stock's return and its share in the size of the overall portfolio. While the main focus tends to be on the return of individual stocks, this second factor in the equation is no less important. You can have the very best investment, but if its representation in the portfolio is minimal, then its impact on the overall portfolio return also will be quite limited. The reverse is of course also true. If you have a high-loss investment in your portfolio, its impact on total return will be all the greater the more space it occupies in that portfolio.

There exist great variations among investors in their approaches to sizing individual positions in their portfolios. In fact, there is essentially no objectively correct approach. This is a very subjective matter and almost every investor goes about it differently. There are investors who are content with having just 3 stocks. Others have hundreds. Some investors set out clear rules in advance – for example, to have 10 investments or 30 investments, of the same size, various sizes, and so forth. Other investors do not specify such numbers at all and act more instinctively. Some build portfolios that are narrower and more concentrated, others portfolios that are broadly diversified. Some investors frequently rebalance their portfolios to stick as closely as possible to their intended allocations while still others leave portfolios to develop as they will, and so on. Each of these approaches has something positive to be said about it and something open to criticism. There exists no objective correctness here.

Position sizing can be a very complex matter. Imagine that you have two positions in your portfolio and that each makes up 50% of it. When you will have more money to invest, you probably will give preference to the one that is currently more attractive. That's still an easy task. But now imagine that you have two positions in your portfolio, with the more attractive one making up 80% of the total and the less attractive one making up 20%. Into which of these would you now invest your newly investable funds? Into the more attractive one, which is already by four times the largest in the portfolio, arguing that it is more attractive, or into the less attractive one, arguing that it is better to diversify the portfolio more? There is no easy answer to that. Moreover, this is not just a binary issue, meaning that it is not a choice between one or the other, but there exist infinite ways in which the new money can be divided between the two stocks in different proportions. If we were to ask ten investors what they would do in this case, we probably would get ten different answers.

In reality, this allocation task is far more complex. For example, you may have an existing portfolio of 20–25 stocks. Each of them has a certain weight, each has a different expected return and different risk. Moreover, let's say you also have another 20–25 stocks that are not currently in the portfolio but are hot candidates to be included. The variants for portfolio composition are indeed boundless. Moreover, portfolios are constructed and managed not in a static world but in a world that is dynamically evolving, wherein stock prices and portfolio weights are constantly changing, and in which investors' perceptions of the expected return and risk of individual stocks are also changing.

So, how do we determine the size of individual positions in Vltava Fund? We try to keep the number of positions in the portfolio between 20 and 25. This is a number that we (of course, quite subjectively) consider ideal. It provides more than sufficient room for diversification, but at the same time it is not too high, so it does not prevent us from having a portfolio that is relatively concentrated and focused upon those investments wherein we most like the combination of risk and return. The ten largest positions typically make up about 70% of the portfolio.

Years ago, we developed an internal three-factor model for specifically determining the sizes of our positions. The three factors are expected return and its probability, risk, and the size of the position itself. For each stock, we have an idea not only of what is its intrinsic value but also how its intrinsic value might evolve over time and what expected return can be anticipated from it. We are continuously updating these assumptions. Most often we do so quarterly when companies announce quarterly results, but sometimes this occurs more frequently if some other change or event requires it. For each stock, we also have a view on its risk. For us, that risk is not the volatility of the share price. We're not interested in that. What interests us is the company's business risk. That means the type of company and its business operations, the level of corporate governance, its indebtedness, the return on capital and its allocation by management, the potential for further growth, and so forth. We express the total risk numerically so that it is easy to work with. The third factor then takes into account the present actual size of the position in our portfolio. We put all three factors together in a certain way and the overall model tells us roughly how large the positions should be for each stock in the portfolio. We are aware that any such model does only what one tells it to do, but there are two big advantages in using it. First, it works in real time and with all the latest data that we have available, saving us a lot of manual work and giving us an instant view of what the whole situation looks like. Second, it takes some of the subjectivity and tendency towards inertia out of our decision making.

We use this model to help us in situations when new money comes into the fund to be invested and it also helps us rebalance positions if necessary. We approach portfolio rebalancing cautiously and usually in cases where the need for rebalancing is already quite apparent. The most common case is when a stock's share price shoots up significantly even though its intrinsic value has not changed dramatically. Such a stock then occupies a much larger space in the portfolio than previously. At the same time, its expected return and relative attractiveness compared to other stocks in the portfolio have diminished. If all this exceeds a

certain degree, then there is an incentive to rebalance positions. Another impetus to rebalance is when a share price has not changed much but our view of the company itself has changed significantly, for better or worse. Nevertheless, we do not get carried away with making shifts within the portfolio. These have their transaction costs, and we also don't give in to illusions as to the perfection and accuracy of our internal model. Still, when the model is practically screaming at us that we should make a shift within the portfolio, we usually will do so. After all, both the intrinsic value of the portfolio and its expected return are a function of the size of individual positions, among other things. In making small adjustments, we strive continually to push both upwards.

In that part of the model dealing with the expected returns of individual stocks and the probabilities for their fulfilment, we put a lot of emphasis on probability. Our experience and our analyses lead us to believe that it is usually better to prefer an investment that has a lower expected return but where the return estimate is both more reliable and more accurate, which is to say that it has smaller probability variance. Repeating these less risky, more predictable, but seemingly lower-return investments paradoxically leads to higher long-term returns than does investing in equities having higher expected return in certain circumstances but whose estimation is less reliable, has lower probability, and often is even speculative in character. This is one of the reasons, among others, why you are more likely to find lower-risk investments in our portfolio and also indirectly explains why we rarely lose money on an investment.

An advantage of our investment approach is that we are a global equity fund, we do not impose any regional, sector, or other similar restrictions in advance, and we are not, as is the case with passive investing, slaves to the composition, price, and risk of an index that is copied. In fact, the only really hard constraint we have on portfolio construction is the legal requirement that no more than 20% of the portfolio be invested in the stock of any one issuer. Internally, we have other limits that we establish for ourselves to manage risk, but these are set in such a way that, in actual practice, we are not prevented from being almost completely free to pick individual stocks in a bottom–up manner, that is to say, according to their particular attractiveness and with an investment risk much lower than that of the market as a whole. The markets offer ideal conditions for this activity. Today, most money is invested passively by investors who do not care what they buy or how much they pay for it. The proportion of active investors who are actually engaged in analysing individual titles is, in my opinion, by far the smallest I have ever seen in my more than 30 years of investment experience. While much of the money is chasing a handful of the most expensive major stocks more or less just because they take up a lot of space in the indices, active value investors can choose among much less expensive and in many cases faster growing companies in segments of the market that are completely outside the mainstream money flow and in a relatively low-competition environment. Let us hope that the predominance in the markets of passively invested money will last as long as possible.

Changes to the portfolio

We sold Crest Nicholson and CVS. We bought OSB Group.

The impetus for the sale of Crest Nicholson's shares came from the outside. One of its competitors, Bellway, announced that it was considering a takeover. We expect that Bellway will proceed with this move and that it will make a formal offer to Crest Nicholson's management and shareholders. The company intends to pay with its own shares. Crest Nicholson shareholders will receive Bellway shares in exchange for their shares in a certain ratio and the two companies will merge. Evidently, the market also expects the takeover to occur, because the share prices of Crest Nicholson and Bellway immediately began to reflect the intended exchange ratio. Because Bellway is much larger than Crest Nicholson, Crest Nicholson's share price began to reflect Bellway's share price and – at least from an investment point of view – Crest Nicholson shareholders effectively have become Bellway shareholders already. We did not want to hold Bellway shares in the future and therefore sold the Crest Nicholson shares.

CVS used to be a very popular stock in the markets. The share price growth, along with investor optimism, peaked sometime in mid-2015. Thereafter, investor enthusiasm gradually began to wane and criticism of management's capital allocation surfaced. The criticisms intensified especially in late 2017, when CVS announced its acquisition of the health insurer Aetna for USD 69 billion. This price was very excessive and the acquisition also saddled CVS with a large debt burden for many years to come. The stock price responded with further gradual, significant decline. The stock came onto our radar in 2020, when it was very cheap. CVS's business looked solid to us and generated strong free cash flow. Our positive view of the company was reinforced when CEO Larry Merlo announced his departure in that year. He had been behind the acquisition of Aetna, and new CEO Karen Lynch, who had been Aetna's CEO up until that time, announced that her main goals would include reducing debt and returning excess cash to shareholders. The poor acquisition of Aetna was not her doing and she had enjoyed a good reputation as Aetna's CEO. We succumbed to the belief that overpriced acquisitions were a thing of the past and that the new management would allocate CVS capital more efficiently. We were wrong. For a while, it looked like management was on the right track and the share price was rising. But then management reverted to its original acquisition practices. CVS announced two more large acquisitions in 2022 and 2023. These were Signify Health and Oak Street Health. The prices of both acquisitions made no sense to us at all. We realised that relying upon management to begin behaving rationally in terms of capital allocation was not enough, and particularly so in cases of companies where this has not been the case in the past. So, we began gradually to reduce our position in CVS and now the company is no longer in the portfolio. Had we reacted faster, we could have made more money in this stock. In any case, we regard CVS to be our biggest buying mistake of recent years. In the hands of more capable management and with a rational allocation of capital, CVS stock could be at three times its price today. In this instance, we underestimated the negative impact of the human factor on the value of the company. This is a very important lesson for the future.

Shares of the British OSB Group constitute a new addition to Vltava Fund's portfolio. This is a smaller and very specialised bank that provides mortgages to professional lessors of predominantly residential (buy-to-let) properties. It has a long tradition and a strong position in this market segment. Tax changes in the UK since 2016 have made it easier to own residential property through an Ltd company, and especially if the owner holds multiple

properties. Traditional large banks have more or less pulled back from lending to professional "buy-to-let" (or BTL) entrepreneurs, leaving the market opportunity to smaller and specialist institutions such as OSB. The opinions occasionally expressed suggesting that the BTL business is risky are, in our opinion, not grounded in reality. We think BTL is less risky than lending against properties that are occupied by their owners. OSB's long-term results demonstrate this. Allowances for bad loans are typically in the lower tenths of 1 per cent (ca 0.25%). This is a very low number and indicates low-risk lending. In addition, loans are pledged against properties with an average LTV (loan-to-value) ratio of 64%. OSB is a bank whose loans are fully funded by deposits on the liabilities side and is not dependent on the availability of bond financing or the interbank market. OSB is remarkably efficient, having a cost/income ratio of around 30% that almost any other bank would envy. Long-term ROTE (return on tangible equity) is above 15% and ROE (return on equity) is more or less the same. The bank regularly pays a large dividend and at the same time buys back its own shares. For such an established and quality business, we would not expect it to trade at a price below book value and with a P/E near 5. The dividend yield is 7%. This is perhaps due to the fact that last year's profits dropped because of specific accounting rules requiring that earnings reflect negative expectations for client behaviour caused by the rapid rise in interest rates. This does not, however, change the long-term attractiveness of the business and so this year should mark a return to normal. How is it possible that such an appealing stock is trading in the market at such a discounted price? Because it is almost completely ignored by most investors. The investments of passive investors (i.e. most of the money in the markets) are placed elsewhere. OSB is a smaller bank, a so-called small cap. Passive money tends to avoid these. It also mostly avoids banking as a sector and, finally, it has shunned UK equities in recent years. British markets have been among the least sought after markets for some time. Taken together, this is almost a perfect storm. But for us, it's absolutely ideal and we can't help but reiterate that we hope the prevalence of passively invested money in the markets continues as long as possible.

Banks are relatively straightforward to value, and a well-performing bank can also be a very good long-term investment. In fact, capital accumulation occurs relatively quickly in banks and compounding of interest can run similarly briskly there. In looking at a bank's balance sheet, one sees that it consists almost entirely of financial items. A bank has no factories, no production lines, no large inventories, no big capital expenditures, no large research and development expenditures, and so on. A bank's profits are almost purely credited to its equity. This, then, means they can grow rapidly at high ROEs.

The long-term return to an investor in bank shares (when reinvesting dividends) is approximately equal to the bank's long-term average ROE while holding constant the price-to-book (P/B) multiple. OSB's long-term ROE can be expected to be around 17% and, as the bank is now trading at 0.8 times book value, the stock's long-term return will most probably exceed the long-term ROE. With its ROE of 17%, we see a reasonable P/B value for the bank somewhere above 1.25 (given that it is a smaller bank). Book value growth per share should also be supported by share buybacks, which are now being made below that price level. OSB's shares are very cheap, and the expected long-term return from holding them (inclusive of reinvested dividends) could be around 20% p.a. Much more that can be expected from the stock market and that is why the shares find themselves in our portfolio.

Daniel Gladiš, July 2024

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