2021

Looking back upon the past year, one could describe 2021 as a year of very strong growth in profitability among the companies we hold in our portfolio. The profits of these companies grew even faster than did the Fund's NAV. Indeed, if we measure the NAV of the Fund against the current profitability of the companies we own, then the Vltava Fund portfolio is cheaper at the end of 2021 than it was at its beginning, despite the past year's substantial growth in NAV. For me personally, that is the main takeaway from a look back.

Regarding the list of titles held, the composition of the Vltava Fund portfolio did not change much throughout 2021. We sold two positions and we incorporated two new ones into our portfolio. Right at the beginning of the year, we sold the shares of Union Pacific railways. After their price had risen greatly, they no longer seemed sufficiently attractive to us. In the final quarter of the year, we sold quite against our will both common and preference shares of Teekay LNG Partners (TGP). I say against our will because in January TGP will be taken over by a private equity fund and its shares will be withdrawn from trading on a stock exchange. Transactions of this sort happen from time to time, and this is nothing unusual. What we find disagreeable in this case is the price at which the takeover is taking place. In our opinion, the USD 17 price is far below the value and potential of the company, and we are racking our brains to understand what motivated the main shareholder, who controlled more than 40% of TGP shares, to sell at such a price. TGP was a solidly profitable investment for us. Nevertheless, we had expected to earn much more from it through coming years. Fortunately, it is not a problem at the moment to find a good place in the market for the cash obtained from the sale of TGP.

There were two new additions to the portfolio last year – shares of the insurance broker Willis Towers Watson and shares of the retail company Williams-Sonoma. I mentioned both purchases already in the previous newsletter to shareholders. At first sight, these were only minor changes. There were many more transactions in the portfolio over the past year, however. Most purchases were directed to shares we have already held in the portfolio. We have been purchasing virtually all the stocks we hold, many of them repeatedly. While we are by no means opposed to anything new and always are looking for new investment opportunities, we generally tend to gravitate to what we already have in the portfolio, to what we know well, and moreover what we see is working out well.

Therefore, our largest positions in the portfolio are predominantly of an older date and the newer ones, purchased let us say within the past 2 years, are rather at the bottom of the table according to size. Nevertheless, also among newer positions are companies that may well remain in the portfolio for a very long time. Stocks such as JP Morgan, Lockheed Martin, CVS or NVR surely have this potential.

Most of the portfolio remains invested in developed markets. In emerging markets we have three positions (Samsung, Sberbank and Quálitas Controladora), and by type our investment into the Japanese Nikkei 225 index differs slightly from the rest of our portfolio.

Three companies that most pleasantly surprised us by their profitability last year are Sberbank, BMW and LabCorp. In Sberbank's case, we have the impression that each new crisis only further consolidates its already relatively dominant market position. Sberbank's profitability is greatly helped by rising interest rates (Russia is one of the few countries where interest rates are more or less at the same level as inflation) and low costs for bad loans. Sberbank continues to be one of the most profitable banks in the world by the absolute amount of its profit, and perhaps it is the most profitable of all the world's big banks according to its key ratios. Last year's profit per share is expected to be 55 roubles and the dividend around 27 roubles. If we take into account that we first bought Sberbank stock for 90 roubles, then, relative to the original purchase price, the current earnings yield (the inverted value of the P/E) is 61% and dividend yield 30%. That shows how much Sberbank's profits have increased over that time.

BMW is another interesting case. In a year that was marked by a shortage of chips and therefore also by lower global automobiles production, BMW achieved a new historical record – by far – in its profitability. That is despite its producing about 10% fewer cars than it otherwise would have had there been enough chips. Generally, demand for cars today significantly exceeds supply and car manufacturers who have so-called pricing power are benefiting from record margins. There is even a relatively large unmet accumulated demand, which should continue to bring carmakers good sales and margins also in years to come. In BMW's case, its profitability will also be pressed up by its plan to increase BMW's stake in its Chinese joint venture from 50% to 75%. China is an immense and profitable market for BMW. If we consider Sberbank to be at the top in terms of profitability ratios, we can say something similar about BMW. The average ROCE (return on capital employed) over the past ten years for BMW's automotive business is about 58%. ROCE is one of the main indicators of a company's capital efficiency, and it is not easy to find a similarly high number either among car companies or among companies in various other sectors.

LabCorp is earning a lot on COVID-19 PCR tests. While 2 years ago this business did not exist at all, today it is driving the company's huge growth in profitability. Although we expect – and hope – that the number of tests performed will drop significantly soon (and by the way, LabCorp is able to do 250,000 of them daily), LabCorp's profitability over the past 2 years has very pleasantly surprised us.

Of course, not all of our companies are doing better than we expected. Lockheed Martin, Quálitas Controladora and Magna fell somewhat short of our expectations last year. In the cases of Lockheed and Magna the reasons are similar: disruptions in the supply and logistics chains. Lockheed uses a great many subcontractors from various countries and could not avoid issues with continuity of supplies. As a result, production will be slightly lower than we had expected. Magna, as a major automotive supplier, suffers indirectly from the same chip shortages as does BMW, for example. In Magna's case, the trouble is that it does not have the same kind of pricing power vis-à-vis its customers as does BMW, and the lower and irregular production is negatively reflected in its profitability.

As a car insurer, Quálitas had a great year in 2020. Due to lockdowns, people drove less and there were substantially fewer accidents. Fewer cars were stolen, too, and all this together meant unexpectedly high profits for Quálitas. Profitability was last year moving back towards normal, as we had expected. That means it was lower, but we had not expected it to come down quite so much. All in all, the profitability of our companies last year was roughly in line with our expectations, perhaps a little better. All the companies, including even those that disappointed us a bit, remained strongly profitable and, most importantly, we expect the overall growth in profitability to continue this year.

As you probably know, we belong to the traditional school of investors where achieving profitability is regarded as the main goal for a business, and we take that same view in choosing investments for our portfolio. Although in the short run stock prices may be wholly disconnected from what is actually going on and from the profitability of individual companies, share price developments in the long run should track the development of companies' profitability. Therefore, we bring into the Vltava Fund portfolio stocks of companies that are regularly very profitable over the long term and whose ability to achieve profits has been tested in a variety of economic conditions. We also make sure that these are companies with high growth potential and, above all, that we do not pay exorbitant prices for their shares. In taking this approach, we may not see the prices of our stocks miraculously and quickly shooting up, but, with minor exceptions, we probably also will avoid stocks that lose us money. We think this is the right approach to take with the money you have entrusted to us.

Character of the market

If you go back to my letter to shareholders from 15 months ago, you will find that I had written that there may be a change in market trend. What was then only a faint and incipient hint has since transformed into quite a brutal bear market in some market segments. For some time, very popular among investors and speculators were stocks they regarded as innovative, disruptive, stocks they thought simply own the future and are worth investing into at virtually any price (and often no matter how dubious the business models of these companies). Similar investment opinions and motifs are nothing new or unusual in the markets. Essentially, they come back in waves of this sort time and again. In any case, they usually end badly.

This latest speculative wave was huge and peaked during the first pandemic summer of 2020. At the end of that summer, however, it had seemed that common sense and an understanding that a stock's purchase price actually matters was slowly returning to investing. Today, it is quite evident that the speculative mania of 2020 will end similarly as did the speculative mania of 2000, and that means by dramatic decline in the prices of stocks that were at the centre of all the speculation. Such market darlings of 2020 as Peloton, Zoom, Pinduoduo, Lemonade, Zillow, Teladoc, Stitch Fix, StoneCo, Nikola, Wix.com, Robinhood, Virgin Galactic, Beyond Meat, Palantir, among others, are today 50%, 60%, 70% or even more below their still quite recent highs.

We had avoided these shares when they were skyrocketing, and maybe we looked foolish for doing so. We did not care, though, because we are not gamblers. Now, however, we can relax and watch how these titles are collapsing and knowing that we have nothing to do with them. That is a much more pleasant feeling. We think that a number of these stocks are still too expensive and that their declines are far from over. In comparison to this, the view of our portfolio is much calmer. Of all our positions, we have only one that is slightly in the red (Burford Capital). All the others are in the black ranging from a few percentage points to several hundred percent.

Current topics

Current market events are dominated by the following three interrelated topics: slow retreat of the pandemic, disrupted supply chains, and inflation.

The pandemic is slowly receding, which is good, but, the truth be told, at the beginning we all probably imagined it would come to an end more quickly. What is important from the investment point of view is that, even as various restrictions are likely still to continue for some time, a total shutdown of the economy as occurred in the spring of 2020 is unlikely to happen. Be that as it may, we are striving to invest on the assumption that the virus will remain with us for still a long time. Some sectors (tourism, airlines, hotels, restaurants) continue to be very much affected, so we would rather avoid these. Most other sectors are more or less close to normal and in some cases even are doing better than usual. On the other side of the proverbial coin, huge government budget deficits in most big countries have bubbled to the surface in the forms of large corporate profits and a big increase in the savings of the population. The high savings rate indicates large accumulated and unsatisfied demand on the consumers' side and, combined with low interest rates, represents the potential for further economic growth. The environment of slowly receding pandemic in combination with economic normalisation has had a very positive impact on the profitability of LabCorp, JP Morgan and Sberbank in particular.

Various economic closures and other restrictions have impacted negatively upon the smooth running of supply chains around the world. The notion of a smoothly functioning global economy has proven subject to serious fracturing. The changing structure of consumer demand, which has partly shifted from unavailable services towards goods, has also played a role, and the world has not been able to respond adequately. All these dysfunctional relationships will even out over time, because both people and firms have the ability to adapt to new conditions. Ironically, disruption of supply chains has had a very positive effect on the profitability of BMW and Samsung and, on the other hand, a negative effect on the profitability of Magna and Lockheed Martin.

The biggest issue nevertheless remains inflation. It is much higher and more persistent than most central banks had expected. Unfortunately, the response of central banks remains often inadequate. The U.S. Federal Reserve and European Central Bank, for instance, have not yet lifted a finger against inflation and are probably praying that it will go away on its own. There is a conspicuous asymmetry in their approach to solving problems. As soon as inflation seems low, central banks loudly announce that they will do "whatever it takes" to push it higher, but as soon as inflation gets out of hand to the upside, they do nothing. As I have said earlier, part of the problem may be that central bankers are generally so young that they have never in their lives had to fight higher inflation. The overall environment with record low negative real interest rates and highly pro-inflationary budget deficits is still conducive to high inflation.

Here, too, our earlier words come to mind. We have been saying already for some time that we as investors will be operating in an environment of negative real rates in the long term and that the scissors between inflation and interest rates will tend to open up. That is exactly what is happening today. We expect more of the same as we go forward.

Just as inflation impacts people differently depending on their class, income and spending structure, assets and liabilities, firms also are impacted variously. Some benefit from inflation and some suffer from it. In our case, companies like BMW, Crest Nicholson and Sberbank are currently benefiting most from the inflation. Inflation, as a general increase in the price level of goods and services, tends to push the numbers up in nominal terms on companies' income statements and balance sheets. This is logical. It also tends to push up stock markets in nominal terms over the long term. A good historical example is provided by the stock markets of countries that are or have been in the past struggling with high inflation for a longer time (e.g. Argentina, Brazil, Israel). In these countries, inflation has pushed stock indices incredibly high. In nominal terms. In real terms, however, which means after accounting for the effect of inflation, this has not been so glorious.

The current high inflation also will tend to push up stock indices in nominal terms. There will be a tug of war between rising profits and the impact of potentially rising interest rates. If the latter were to rise very substantially, they would push stock (and other asset) valuations downwards. Central banks of most western countries have their hands tied on raising rates, however, as they know very well that in many cases highly over-indebted government budgets would not be able to sustain it. And so the path of least resistance is marked by deeply negative real rates, which on the one hand help to wipe away the real level of government debt but on the other erode the real level of people's deposits just as quickly. I do not like this situation, but it does not matter what I like or dislike. We realise that we must invest not according to how we would like the world to look but according to what we think it will look like. And I have to say that the environment I have described above, and which is likely to be with us for the long term, is quite conducive to long-term growth in stock prices.

Daniel Gladiš, January 2022

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