NOMAD INVESTMENT PARTNERSHIP

LETTERS TO PARTNERS

2001 – 2013

Nicholas Sleep

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3rd June 2014

Mr Warren Buffett
Berkshire Hathaway Inc
3555 Farnam Street
Omaha
NE 68131
USA

Dear Mr Buffett

After thirteen happy years of running the Nomad Investment Partnership, Zak and I have decided to close the fund. The process requires us to return cash to our investors and so, after many years as shareholders in Berkshire (ten, I think), we have recently sold our shares.

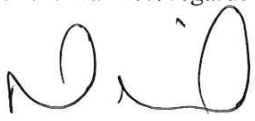
It appears to all the world that the performance that Nomad has enjoyed over the years was created by Zak and me. That is not the case. As time goes by, the performance that our clients have received is the capitalisation of the success of the firms in which we have invested. In other words, the real work is done by you and the good people of Berkshire.

The purpose of this letter is to say a very big thank you, and to let you know that you have made a real difference. Nomad was not a particularly large fund, but over the years it did make around U$2bn for its clients, which were predominantly charities and educational endowments. Berkshire was a big part of that. That strikes us as capitalism working well.

For our part, Zak and I are keen to leave the professional industry behind, and spend our time in more caring pursuits. Zak has his various charitable causes and I have it in mind to set up a centre to provide respite care. Both of these activities will require long term funding, and so whilst you will lose us as professional investors, we will be able to repurchase our shares both privately and for the charities that we run. You don't get rid of us that easily!

We will be keeping the office, and a new sign will be hung above (our somewhat shabby) front door. We look forward to seeing you at the next AGM, and extend an invitation to visit us at Burnsall Street.

With the warmest regards



Nick Sleep

SLEEP, ZAKARIA AND COMPANY, LTD. IS THE INVESTMENT ADVISOR TO THE NOMAD INVESTMENT PARTNERSHIP AND IS AUTHORISED AND REGULATED BY THE FINANCIAL CONDUCT AUTHORITY, NO 451772.

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WARREN E. BUFFETT, CHAIRMAN

June 12, 2014

Mr. Nick Sleep
Sleep, Zakaria and Company, Ltd.
1A, Burnsall Street
London, SW3 3SR
England

Dear Nick:

Thanks for sending along the update. You and Zak have made the right choice. I predict you will find life is just beginning.

Best regards.

Sincerely,

Warren E. Buffett

WEB/db

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Nomad Investment Partnership

Annual Letter

Cumulative returns for the period ended December 31st, 2013

To December 31st, 2013:	Nomad Investment Partnership	MSCI World Index (net) US$
Trailing:	%	%
One year	62.2	26.7
Two years	126.8	46.7
Three years	104.3	38.6
Four years	194.0	54.9
Five years	404.1	101.3
Six years	176.6	19.4
Seven years	235.3	30.2
Eight years	280.9	56.3
Nine years	316.5	71.1
Ten years	409.8	96.3
Eleven years	815.5	161.3
Twelve years	827.4	109.3
Since inception (September 10th, 2001)	921.1	116.9
Annualized since inception:	%	%
Before performance fees	20.8	6.5
After performance fees	18.4	
Value of a dollar invested at inception (pre-fees)	$10.21	$2.17

The figures above are unaudited, presented on a cumulative, percentage gain basis and, as ever, are before fees. We present results in this way as Nomad's refundable performance fee and time dependent performance fee hurdle mean that the net-of-all-fees results will vary with subscription date, and from investor to investor. Partners will, therefore, each have their own, unique, net-of-all fees experience of investing in Nomad. As a guide, we have also detailed the net-of-all-fees results from one point in time, in this case since inception. An index is used in the table to crudely place our results in context with a broad swathe of share prices from around the world. One of the reasons that Nomad is Nomad is that Zak and I spend almost no time thinking about stock market indices. We do not feel strongly about the merits, or otherwise, of this particular index, indeed its continued inclusion here may have more to do with continuity than relevance, and we would encourage partners to employ another benchmark if they feel it is more helpful to them. Whatever the yardstick, we ask only that Nomad be compared over the very long-term. Below, the same pre-fee results are presented in discrete annual increments. In our opinion, it is probably the upper table that is most useful in assessing long-term investment performance.

To December 31st:	Nomad Investment Partnership	MSCI World Index (net) US$
Calendar Year Results:	%	%
2013	62.2	26.7
2012	39.8	15.8
2011	-9.9	-5.5
2010	43.9	11.8
2009	71.5	30.0
2008	-45.3	-40.7
2007	21.2	9.0
2006	13.6	20.1
2005	9.2	9.5
2004	22.1	14.7
2003	79.6	33.1
2002	1.3	-19.9
2001 (inception September 10th)	10.1	3.6

The annualised return (i.e. before fees) of an investment made in Nomad on September 10th 2001, when Zak and I began managing the Partnership, has been just over twenty percent per annum, as of January 1st this year, whilst the average share, as reflected in the index above, would have seen a return over the same period of around six and a half percent per annum. This fourteen percent or so annual advantage, multiplied out over many years, means that a dollar invested in Nomad all the way through has now grown to be worth just over ten dollars, whilst a dollar invested in the index over the same period would now be worth just over two dollars. Put a slightly different way, and in net asset value terms (i.e. after fees), Nomad has compounded at over eighteen percent per annum, whilst the index has managed an annual six and a half percent.

It appears to all the world that the performance detailed above has been created by Zak and me. That is not the case. In the sense that we could have picked different stocks and performance been poor, then we did avoid a worse outcome. That argument runs in reverse too: performance could always have been better. Even so, in

aggregate, the fund management function, evened out over all shareholder experiences, does not add value per se: it only shuffles wealth created elsewhere. As time goes by, the performance that you receive, as partners in Nomad, is the capitalisation of the success of the firms in which we have invested (minus our fees!). To be precise, the wealth you receive as partners came from the relationship our companies' employees (using the company as a conduit) have with their customers. It is this relationship that is the source of aggregate wealth created in capitalism. If you see them at the bar buy a drink for Messrs Bezos, Robertson, Fernandes, Sinegal, Buffett, Steiner et al, (then call us, that would be quite some bar!). All Zak and I have done is catch some better waves and try to ride them to the shore. Riding waves is not an expensive activity and Nomad's (cost reimbursement) management fee remains around ten basis points per annum.

This is the twenty-fifth letter to investors over fourteen calendar years. In these letters we have tried to cover the philosophy and methodology Zak and I use to approach the problem of investing. We keep our discussions to as high a level as we can manage in the belief that, in the long run, the high level is all that matters. In these letters we have therefore discussed business models, incentive compensation, capital allocation, mistakes, more mistakes, even more mistakes, lots on psychology and how to think, lots on attitude and so on. Whilst we may only write twice a year, we own shares for such long periods (if the current rate of portfolio activity should persist) that we write around twenty letters during the life of the average investment – that's a huge amount! In previous letters we have also discussed the psychological traps inherent in a more loquacious approach (been there, done that, don't want to do it again!). At its heart, investing is simple, and to make it seem anything but, with the frequent repartition of short-lived facts and data points, may be a conceit. Indeed, it could be argued that a running commentary obfuscates a discussion of the things that really matter. Whilst we have covered many of the topics relevant to long term investing in these letters already, there is a topic that we have not discussed too much and that now affects the Partnership in a significant way. That is regulation (no moaning at the back).

Since 2001, the number of regulators claiming oversight over the Nomad ecosystem has doubled to four, and the scope of the regulation is up by, we estimate, one order of magnitude. The new Financial Conduct Authority, the fourth iteration of the UK regulator since Zak and I have been in the industry (the others being: the Investment Management Regulatory Organisation, IMRO; the Securities and Futures Authority, SFA; and the Financial Services Authority, FSA), may soon require various parts of the Nomad ecosystem to re-register for authorisation to function as investment service providers. Whilst the process of re-registration can be seen as an expensive form filling exercise, and we are happy to disclose whatever is required (less so about writing the cheques), the nature of the new regulation is unlike its predecessors. Gone is the light touch of self-regulation and instead the mechanism, and perhaps the political will, exists to be far more controlling. For instance, the new regulation seeks a separation of risk management from portfolio management (we are scratching our heads a little on what that means and the regulation does not define the terms) and has already taken the form of mandating remuneration policies (but is oddly silent on dividend payments). As with all new rules there seem to be some anomalies: it appears that an investment advisor in London may be treated as if it is an offshore partnership's general partner for the purpose of regulation, but the same government

would view the London entity as a subcontracted investment adviser for the purpose of taxation and control – a contradiction that may not be long lived, especially as governments seek to balance their budgets.

It seems to us that the regulatory landscape is not supportive of small, simple investment boutiques that are not part of whatever problem the regulation seeks to solve. We might wish otherwise, but the halcyon days of the budding stock picker running his friends and family partnership from the sunroom at home at 5505, Farnam Street, Omaha (an image so important to Zak and me) are long gone. In our opinion, given time, the barrier to entry presented by the new rules may cause considerable industry consolidation (a desired outcome from a regulatory standpoint – let's face it, regulation is expensive to do) but consolidation will, in the end, bring with it an unintended, concomitant increase in market fragility, to paraphrase Nassim Taleb. It also seems to us, on an anecdotal basis, that those who increasingly populate the industry are the types who pay others to do their work for them (just witness the Cambrian explosion of service providers offering to act as intermediaries). As some complex financial institutions may be discovering today, if the proprietor has abdicated responsibility to the point of not knowing what is going on, then that is not healthy either.

All this has come about because other people have lied and stolen. In essence we are required to now prove that we are not Bernard Madoff but, unlike Mr Madoff, there is no potential for us to earn our way to a lighter regime through good behaviour. Nor is any allowance made for the fact that we invest for the very long term or that we are a simple fund. Indeed, Nomad is treated the same as a leveraged, long/short hedge fund complex that deals in exotica and trades constantly. Like traffic speed limits, the regulation seeks to moderate all behaviour for the general good, and we have lived with those restrictions quite happily (well, almost). Even so, in our opinion, what is really required in order to bear down on the liars and cheats are empowered, detectives-cum-regulators asking questions of those whose practices don't sniff right. And if you really want to change industry behaviour, I'll whisper this, tax short term investing. Instead, we get more blanket rules for everyone.

Housekeeping

One of the effects of being closed to subscriptions and only open periodically is that, especially in the current regulatory climate, the Partnership's governing documents can be soon outdated. The investment advisory agreement and prospectus will now be reviewed to reflect (this list is not exhaustive): our status with the SEC; the American FATCA and European AIFMD requirements; our de-listing from the Irish Stock Exchange (which, eh hum, occurred several years ago), and the appointment of Ralph as Nomad's new director following Martin's retirement. That should do it for 2014! The refreshed documents will be sent to partners in due course.

Zimbabwe

In the mid noughties, economic conditions were almost uniformly favourable around the world, and equity market prices reflected the prevailing conditions. In a perfect world, Zimbabwe was a glaring anomaly. In Zimbabwe one could purchase industrial assets, often monopoly or near monopoly operations, for much less than the cost of

those assets: cement plants for ten cents on the dollar and breweries for one quarter of the cost of the stills and lorries.

So we rolled up our sleeves, crossed the border from South Africa, and set about our work. We identified some reasonable investment candidates but the first wrinkle to overcome were exchange controls that artificially over-valued the Zimbabwean dollar. These controls could be legally side stepped through buying shares in firms listed on the Johannesburg (South Africa) stock exchange that also had a listing in Harare (Zimbabwe), re-registering the Jo'berg shares in Harare, and then selling the shares on the Harare stock exchange. The process took some time, but the uplift in purchasing power was many fold above the rate offered by the central bank for cash transactions. With Zimbabwean dollars we could then make investments. We chose three sectors in an attempt to diversify from nationalisation risk, and to invest in businesses with large, powerful, major shareholders who could protect their/our business interests. At least we hoped. To this end we purchased shares in a cement company, brewery and construction/engineering firm.

In the years that followed, the country has lived through: a decline in economic activity of, at one stage, perhaps as much as one half; hyperinflation; the abandonment of the local currency by the central bank as a means of exchange; the suspension of the stock market (and associated zero value attributed to our investments); violent, forced nationalisation of privately owned farms; the attempted assassination of political opponents; and a coalition government which included, and continues to include, the incumbent President Mugabe. Even though Zimbabwe is far from normalised, Nomad's investments have risen in price between three and eight fold in US dollars and, following the sale of our final Zimbabwean investments last year, the dollars have been remitted to Nomad's bank accounts in London. It is quite a story, but not one we would repeat in a hurry (we can do better with the compounding businesses these days – and they are much less stressful). Enclosed with (the analogue version of) this letter is a one hundred trillion Zimbabwean dollar bank note issued at the peak in hyperinflation (we have a limited number, and so only one note has been enclosed per limited partner. If your letter did not contain a note it is because we may have multiple addressees per limited partner interest, and so the note will be with one of your colleagues). Today the note is worthless (absent an eBay novelty value). But we thought you might like a hundred trillion dollar bill (and who wouldn't?) as a souvenir of Nomad's adventures in capitalism (frame it for the study/boardroom?). (Partners who are more digital in their reading habits may claim their note with an email to Amanda at Galactic HQ – we only have so many, so one application per limited partner, please.)

A final note on Psychology

It is almost ten years since Barry Schwartz published his popular psychology book "The Paradox of Choice". To précis part of the book: Schwartz observed that western society tends to view choice as a good thing, and more choice as better still. In his local supermarket Schwartz counted one hundred and thirty or so different salad dressings, excluding the dozen olive oils and balsamic vinegars should the pre-made salad dressings not offer enough choice! In his local electronics store he found over six million possible combinations of hi-fi components. Even though consumers were being offered what seemed to Schwartz to be an ever-increasing plethora of choice to

meet their needs, he could find no correlation with increased happiness. Instead, he hypothesised, that with all the choice came the (subconscious) expectation that the outcome ought to be perfect, and this expectation rendered the actual choice made as disappointing in comparison. It was as if too much choice was making us unhappy.

Schwartz does not make mention of it directly, but the problem is not confined to consumer decision-making. The public stock markets have many tens of thousands of potential investments, and the price of each of those changes almost constantly. The number of possible profit or loss combinations would make Schwartz's hi-fi store look like a multiple-choice test. It is very easy, therefore, to feel unhappy about one's investments. Indeed, on any one day, month, year it is highly likely, indeed statistically almost certain, that one's chosen combination of investments will lag alternatives – there will always be someone who did better.

In a recent Nomad letter (June 2010) we wrote…

"*Readers that make it to the end of our letters (we may be flattering ourselves), including the footnotes (we may be deluding ourselves!), may recall the story we retold of the Ferrari 250 GTO bought by a collector in the 1960s for the effective price of £750. The beauty of the story is that although the car is one of the most valuable in the world, the collector still has his car today. A different 250 GTO has recently changed hands, and the price…US$20m!"*

…Stop Press: a Ferrari 250 GTO changed hands recently for U$52m! That represents an annual return of over twenty percent for around fifty years. There is always something going on that makes Nomad's performance look a bit weedy! Before you show your disappointment and reach for the rotten fruit to throw our way, I think it is time we got back to dealing with the regulations (x4).

We wish you a very Happy New Year,

Nicholas Sleep

Our footnotes

There is, we are told, a ticket kiosk at a railway station somewhere in India with a sign above the window that reads, "*No Bamboozlement Here*". It is in the same spirit that we attempt these cautionary words. Disclaimers boil down to the following statement – if you choose to believe any of this, then you are on your own. Yikes! It will be hard for us to escape this conclusion too, and it makes little sense for us to do anything but disclaim liability for errors, omissions and offer no warranties – please, check everything we say, let us know when we are wrong and forgive our errors. We do promise you this: we are human, we make mistakes, but our mistakes are honest ones. Although we do not intend to mislead, we also cannot guarantee the information in these letters, or that some of our ideas may be interpreted in ways we do not intend. As investors we are trying to do as good a job as we can and we write these letters in good faith to inform and educate partners about our actions and thinking in the context of the Partnership. We hope that they will be read in the same spirit in which they are written.

Common sense tells you that the price and value of shares can vary greatly, and whilst we do not aim for this, we also recognize that permanent impairment of capital is possible. Our Partnership is concentrated in relatively few investments, perhaps more concentrated than many others, and as such

our results will be more volatile than many of our peers. Nomad is also a very long-term Partnership. We do not think it is suitable for investors with time frames less than five years. We also do not think Nomad is suitable for investors overly conflicted with principal-agent issues. If you are at all uncomfortable then, we suspect, Nomad is not for you.

The Nomad Investment Partnership has had two General Partners: Marathon Asset Management for the period from inception in 2001 to September 2006, and Sleep, Zakaria and Company from September 2006 until the present day. Zak and I have been responsible for the investment decisions of the Partnership since inception, formerly as employees of Marathon and then at our own firm, which was set up for the purpose of managing Nomad. The adventure continues…

Some notes on housekeeping (stay awake at the back!)

This is the annual letter and, combined with the interim letter sent to investors in July, is the main format we use to communicate with our partners. In these letters we have tried to honestly and thoroughly provide all the information we would seek if the tables were turned and we were investors in someone else's fund. We own shares for very long periods and we are conscious that more frequent or detailed reporting may be unnecessary and even counterproductive. A copy of our magnum opus, the full Collection of Letters, is available upon request from Amanda at Galactic HQ (amanda@sleepzakaria.co.uk). Lots of coffee required. Partners in Nomad will also receive a full copy of our Schedule of Investments by separate post, every six months, which lists all of our investments in detail. In addition, in the spring you will receive Nomad's annual accounts, audited by Grant Thornton. Each month statements of account are sent to you by Nomad's administrator (not us!), Phoenix Financial Services in Dublin, Eire. Please call Gavin Gray and his team (+353 18 450 8161) with your statement queries. As should taxable US investors as Gavin and his team prepare their tax certificates (1099s) as well.

Clients should always consider Zak and me to be available at the end of the phone, and our (somewhat shabby) front door open to visitors. And whilst we welcome your company, please don't be too disappointed if we don't have much that is new to say: we hope it is in these letters already.

Legal footnotes

Performance numbers are produced by Phoenix Fund Services, Nomad's administrator, and have been audited by Ernst and Young to 2011, and from then on by Grant Thornton in their annual audits that follow publication of our letters.

In our letters we refer to both limited partners in the Partnership, and common shareholders in the Nomad Investment Company (feeder fund) as "partners". We do this to convey a relationship we seek in which our investors are partners in a shared experience and destiny, in which they too have something to contribute. We do not mean to suggest that there is a partnership, in the strict legal sense of the word, between the shareholders in the feeder fund and Nomad, or Sleep, Zakaria and Company, Ltd.

This document is issued by Sleep, Zakaria and Company, Ltd., which is authorized and regulated by the Financial Conduct Authority (FCA) (No. 451772). This document is only sent to people who have an interest in receiving it, and is not for onward distribution. This communication is being made only to and is directed only at: (a) persons outside the United Kingdom; (b) investment professionals, as defined in Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the "Order"); or (c) high net worth companies, unincorporated associations and partnerships and trustees of high value trusts as described in Article 49(2) (a) and (d) of the Order, and other persons to whom it may otherwise lawfully be communicated, falling within Article 49(1) of the Order.

The Nomad Investment Partnership is not a recognized scheme under the Financial Services and Markets Act 2000 ("FSMA"). Given the nature of Nomad's investor base, recourse to the FCA and the Financial Services Compensation Scheme may be limited.

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Nomad Investment Partnership

Interim Letter

For the period ended June 30th, 2013.

Cumulative results to June 30th, 2013.	Nomad Investment Partnership	MSCI World Index (net) US$
Trailing:	%	%
One year	36.9	18.6
Two years	29.4	12.7
Three years	124.8	47.0
Four years	210.5	62.1
Five years	159.4	14.3
Six years	112.3	2.1
Seven years	174.8	26.1
Eight years	202.7	47.5
Nine years	282.2	62.3
Ten years	439.1	101.3
Eleven years	563.0	96.5
Since inception (Sept 10th 2001)	660.2	85.6
Annualized since inception:		
Before performance fees	18.7	5.4
After performance fees	16.3	
Value of a dollar invested at inception (pre-fees)	$7.60	$1.86

The figures above are unaudited, presented on a cumulative, percentage gain basis and, as ever, are before fees. We present results in this way as Nomad's refundable performance fee and time dependent performance fee hurdle mean that the net-of-all-fees results will vary with subscription date, and from investor to investor. Partners will, therefore, each have their own, unique, net-of-all fees experience of investing in Nomad. As a guide, we have also detailed the net-of-all-fees results from one point in time, in this case since inception. An index is used in the table to crudely place our results in context with a broad swathe of share prices from around the world. One of the reasons that Nomad is Nomad is that Zak and I spend almost no time thinking about stock market indices. We do not feel strongly about the merits, or otherwise, of this particular index, indeed its continued inclusion here may have more to do with continuity than relevance, and we would encourage partners to employ another benchmark if they feel it is more helpful to them. Whatever the yardstick, we ask only that Nomad be compared over the very long-term. Below, the same pre-fee results are presented in discrete annual increments. In our opinion, it is probably the upper table that is most useful in assessing long-term investment performance.

Calendar Year Results:	Nomad Investment Partnership	MSCI World Index (net) US$
	%	%
2013 (year to date)	20.8	8.4
2012	39.8	15.8
2011	-9.9	-5.5
2010	43.9	11.8
2009	71.5	30.0
2008	-45.3	-40.7
2007	21.2	9.0
2006	13.6	20.1
2005	9.2	9.5
2004	22.1	14.7
2003	79.6	33.1
2002	1.3	-19.9
2001 (inception Sept 10th 2001)	10.1	3.6

The annualised return (i.e. before fees) of an investment made in Nomad on September 10th 2001, when Zak and I began managing the Partnership, has been 18.7% per annum, as of June 30th this year, whilst the average share, as reflected in the index above, would have seen a return over the same period of around 5.4% per annum. This thirteen percent or so annual advantage, multiplied out over many years, means that a dollar invested in Nomad all the way through has now grown to be worth $7.60, whilst a dollar invested in the index over the same period would now be worth around $1.86. Put a slightly different way, and in net asset value terms (i.e. after fees), Nomad has compounded at 16.3% per annum, whilst the index has managed 5.4%.

A Different Take on Incentives.

When is six percent, not six percent? Stuck? May we suggest an answer: when it is Nomad's performance fee hurdle? That raised an eyebrow here too, not least because

the hurdle is always more than six percent, sometimes a lot more than six percent! Perhaps I should explain.

Zak and I sat down about ten years ago, over a sundown glass of Chardonnay at a bar in a Californian hotel, and pencilled the Nomad fee arrangements on a spare sheet of paper. It did not take long. We concentrated on the correct philosophical approach to incentives, and so the job was easy: the management fee should not be a profit centre as we do not create value through managing the Partnership per se (hence our break-even cost reimbursement management fee); the performance fee should respect the notion of the opportunity cost of capital (and long bonds had been six percent or so); and if we owned shares for long periods, then performance fees should be at risk for an extended period too. Done, now where did the waiter go?

We did not dwell too long on the heinously complicated practical implications of accounting and administering the arrangement, nor did we foresee the need for a new administrator, a new director associated with the administrator, huge legal fees, and that a six percent hurdle is hardly ever six percent. Oh well, the best laid plans etc… The reason that six percent is not six percent is two fold: a linked ten percent loss and a ten percent gain are not mathematically equivalent (duh), and Nomad's performance fee reserve is itself invested in Nomad shares and so is doomed to, in effect, buy high (accrue) and sell low (reimburse). Zak has set himself the task of finding a case when the six percent hurdle might be less than six percent. He may be some time.

If our naivety had been pointed out to us on that sunny evening we would have recognised the issues but I don't think we would have changed anything. It is not very important to us that a six percent hurdle has been well over ten percent in the recent past, and we would certainly never do anything to lower it. Our slightly unconventional approach to being paid may be worth explaining, and so in this letter I will try to describe our attitude to the financial rewards that can come with running the Partnership.

We have written quite a lot about the power of financial incentives over the years, most recently the extent to which incentives (and rules) can de-moralise behaviour. You could describe the cause of the financial crisis in these terms. And whilst conventional wisdom has, in our view, quite correctly drawn a Pavlovian link between financial incentives and behaviour, money is not the only reason that people behave the way they do. Those tasked with setting compensation arrangements may first wish to ask themselves, why do people climb mountains? After all, it is not for the financial rewards – there is more to life than that.

The author, professor and founder of "The Institute for Advanced Hindsight", Dan Ariely, has studied the power of non-monetary incentives. In a recent talk (TED, Buenos Aires, Argentina, October 2012) he described how early academic experiments looking at motivation attempted to record the effect of taking the meaning out of work. This they did by asking people to build model robots from Lego-like blocks in return for a nominal fee. The fee was lowered for each successive robot built until the builder no longer wished to participate. For one group (the "rewards" group), the finished robots were placed carefully on a shelf for all to see.

For the other group (the "Sisypheans"[1]) finished robots were broken up in front of the builder and the parts given back with the invitation to build the next robot (again for a lower fee). The researchers found that the Sisypheans built fewer robots and so stopped at a much higher price than the rewards group. This was broadly expected. What they had not anticipated was the magnitude of the difference, as the rewards group produced more than fifty percent more robots and for a much lower price compared to the Sisypheans. The researchers concluded that having their models destroyed took away some of the meaning the Sisypheans saw in their work, and that the lack of meaning was not outweighed by the pay. On the other hand, the rewards group did not see their role as pointless and were happier making models even though the pay was much less.

In the 1940s the food companies began manufacturing a new product, the powdered cake mix, which was marketed as a time saving innovation as the mix required only the addition of water before baking. To the marketer's great surprise - sales were terrible! Something had to be done and so, almost as an experiment, a new product was launched which required the cook to add fresh eggs, milk and sugar and although it took longer to make, paradoxically, sales improved! Anyone who has laboured through assembling Ikea furniture may understand why. To the builder of flat pack furniture or the baker of cakes, the perceived value of the end product is influenced by the input of the consumer's own efforts. In doing some work themselves the builder, or cook, puts a little bit of meaning, perhaps even a little bit of love, into the product.

Ariely was so taken with this observation that he developed a further experiment. One group was tasked with building a complicated origami model, and were given instruction on how to do so. When the group had finished the researcher took the model away and asked the builders how much they would be prepared to pay the researcher to keep their model. A second group Ariely tasked with building an origami model, this time without instruction, and when they were finished he asked them the same question: how much would you pay to keep your model? The findings were interesting: both groups were prepared to pay much more than the market price for origami models built by professionals, even though their own models were inferior. Moreover, those who had laboured without instruction (and built the worst origami!) were prepared to pay the most to have their models returned. In other words, the normal relationship between price and quality had been inverted by the value one placed on one's own work.

In traditional capitalist thinking, Ariely surmised, we tend to have Adam Smith in mind, and the gains from subdividing pin manufacturing into twelve distinct steps. The efficiency embedded in this approach won the day over Karl Marx's concerns about the estrangement felt by workers from becoming an anonymous cog in a larger process. The debate then, and ever since, has been the battle between efficiency and meaning.

The best entrepreneurs we know don't particularly care about the terms of their compensation packages, and some, such as Jeff Bezos (Amazon) and Warren Buffett (Berkshire Hathaway) have substantially and permanently waived their salaries,

[1] In the Greek myth Sisyphus was tasked by the gods with rolling a boulder to the top of a hill. Each time he reached the top the boulder rolled to the bottom and Sisyphus had to start again. As a punishment for deceitfulness, Sisyphus had to repeat the task for all time.

bonuses, or option packages. We would surmise that the founders of the firms Nomad has invested in are not particularly motivated by the incremental dollar of personal wealth. When we asked Nick Robertson, the founder of Asos, whose paper net worth has increased hugely since we have known him, whether, now he is a rich man, he has thoughts of leaving, his face lights up with the future possibilities of his firm and says he is having more fun now than ever before. In this aspect of his life he has moved on from monetary rewards driving his behaviour, and we are sure the business will be better for it.

The same is probably true for Jim Sinegal before his retirement (Costco), Lord Harris (Carpetright) and some of the other founders of the firms in which Nomad has invested. These people derive meaning from the challenge, identity, creativity, ethos (this list is not exhaustive) of their work, and not from the incentive packages their compensation committees have devised for them. The point is that financial incentives may be necessary, but they may also not be sufficient in themselves to bring out the best in people. In its own little way, this is why Zak and I are quite relaxed about six percent not being six percent. It was an arbitrary number in the first place, and we derive a great deal of value from the meaning of the work we do (challenge, sense of job well done, identity, creativity and so on) not just from the financial rewards (although we will learn to live with those too!). By having an attitude that is somewhat independent of financial rewards, we are sure that Nomad's performance in the long run will be far better too.

Inactivity as a Source of Value Added.

Our portfolio inaction continues and we are delighted to report that purchase and sale transactions have all but ground to a halt. Our expectation is that this is a considerable source of value added! At the time of our initial investments in Nomad's investee businesses, the firms were, on average, around fifteen years old. Take out the two grandparents (Berkshire Hathaway and Costco) and the average falls to twelve years. It is hard to know how this compares to businesses at large (what is the average age of a listed company?), but we do know that the average time S&P500 constituent stocks have been included in that index is twenty-five years. One could guestimate that those firms might have been say, twenty years old on inclusion? At any rate, the statistic helps to illustrate how youthful Nomad's firms are. The runway ahead for our businesses may be very long indeed. Inaction on our part is counter-cultural and deliberate, and is easier said than done. Really. For those used to a more industry-standard level of trading activity, we hope to update you in real time on our level of inaction through our planned "Nomad Inactivity App.", available only in the Amazon App. store, of course. As Berkshire Hathaway Vice-Chairman, Charlie Munger, says, you make your real money sitting on your assets!

As always, we thank you for your gentle approach,

Yours sincerely,

Nicholas Sleep

Our footnotes

There is, we are told, a ticket kiosk at a railway station somewhere in India with a sign above the window that reads, "*No Bamboozlement Here*". It is in the same spirit that we attempt these cautionary words. Disclaimers boil down to the following statement – if you choose to believe any of this, then you are on your own. Yikes! It will be hard for us to escape this conclusion too, and it makes little sense for us to do anything but disclaim liability for errors, omissions and offer no warranties – please, check everything we say, let us know when we are wrong and forgive our errors. We do promise you this: we are human, we make mistakes, but our mistakes are honest ones. Although we do not intend to mislead, we also cannot guarantee the information in these letters, or that some of our ideas may be interpreted in ways we do not intend. As investors we are trying to do as good a job as we can and we write these letters in good faith to inform and educate partners about our actions and thinking in the context of the Partnership. We hope that they will be read in the same spirit in which they are written.

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Some notes on housekeeping (stay awake at the back!)

This is the interim letter and, combined with the annual letter sent to investors in January, is the main format we use to communicate to our partners. In these letters we have tried to honestly and thoroughly provide all the information we would seek if the tables were turned and we were investors in someone else's fund. We own shares for very long periods and we are conscious that more frequent or detailed reporting may be unnecessary and even counterproductive. A copy of our magnum opus, the full Collection of Letters, is available upon request from Amanda at Galactic HQ (amanda@sleepzakaria.co.uk). Lots of coffee required. Partners in Nomad will also receive a full copy of our Schedule of Investments by separate post, every six months, which lists all of our investments in detail. In addition, in the spring you will receive Nomad's annual accounts, audited by Grant Thornton. Each month statements of account are sent to you by Nomad's administrator (not us!), Phoenix Financial Services in Dublin, Eire. Please call Gavin Gray and his team (+353 18 450 8161) with your statement queries. As should taxable US investors as Gavin and his team prepare their tax certificates (1099s) as well.

Clients should always consider Zak and me to be available at the end of the phone, and our (somewhat shabby) front door open to visitors. And whilst we welcome your company, please don't be too disappointed if we don't have much that is new to say: we hope it is in these letters already.

Legal footnotes

Performance numbers are produced by Phoenix Fund Services, Nomad's administrator, and have been audited by Ernst and Young to 2011, and from then on by Grant Thornton in their annual audits that follow publication of our letters.

In our letters we refer to both limited partners in the Partnership, and common shareholders in the Nomad Investment Company (feeder fund) as "partners". We do this to convey a relationship we seek in which our investors are partners in a shared experience and destiny, in which they too have something to contribute. We do not mean to suggest that there is a partnership, in the strict legal sense of the word, between the shareholders in the feeder fund and Nomad, or Sleep, Zakaria and Company, Ltd.

This document is issued by Sleep, Zakaria and Company, Ltd., which is authorized and regulated by the Financial Conduct Authority (FCA) (No. 451772). This document is only sent to people who have an interest in receiving it, and is not for onward distribution. This communication is being made only to and is directed only at: (a) persons outside the United Kingdom; (b) investment professionals, as defined in Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the "Order"); or (c) high net worth companies, unincorporated associations and partnerships and trustees of high

value trusts as described in Article 49(2) (a) and (d) of the Order, and other persons to whom it may otherwise lawfully be communicated, falling within Article 49(1) of the Order.

The Nomad Investment Partnership is not a recognized scheme under the Financial Services and Markets Act 2000 ("FSMA"). Given the nature of Nomad's investor base, recourse to the FCA and the Financial Services Compensation Scheme may be limited.

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Nomad Investment Partnership

Annual Letter

Cumulative returns for the period ended December 31st, 2012

To December 31st, 2012:	Nomad Investment Partnership	MSCI World Index (net) US$
Trailing:	%	%
One year	39.8	15.8
Two years	25.9	9.4
Three years	81.2	22.3
Four years	210.7	59.0
Five years	70.5	-5.7
Six years	106.7	2.8
Seven years	134.8	23.5
Eight years	156.7	35.2
Nine years	214.2	55.1
Ten years	464.3	106.4
Eleven years	471.6	63.3
Since inception (September 10th, 2001)	529.4	71.3
Annualized since inception:	%	%
Before performance fees	17.7	4.9
After performance fees	15.1	
Value of a dollar invested at inception (pre-fees)	$6.29	$1.71

The figures above are unaudited, presented on a cumulative, percentage gain basis and, as ever, are before fees. We present results in this way as Nomad's refundable performance fee and time dependent performance fee hurdle mean that the net-of-all-fees results will vary with subscription date, and from investor to investor. Partners will, therefore, each have their own, unique, net-of-all fees experience of investing in Nomad. As a guide, we have also detailed the net-of-all-fees results from one point in time, in this case since inception. An index is used in the table to crudely place our results in context with a broad swathe of share prices from around the world. One of the reasons that Nomad is Nomad is that Zak and I spend almost no time thinking about stock market indices. We do not feel strongly about the merits, or otherwise, of this particular index, indeed its continued inclusion here has more to do with consistency than accuracy, and we would encourage partners to employ another benchmark if they feel it is more helpful to them. Whatever the yardstick, we ask only that Nomad be compared over the very long-term. Below, the same pre-fee results are presented in discrete annual increments. In our opinion, it is probably the upper table that is most useful in assessing long-term investment performance.

To December 31st:	Nomad Investment Partnership	MSCI World Index (net) US$
Calendar Year Results:	%	%
2012	39.8	15.8
2011	-9.9	-5.5
2010	43.9	11.8
2009	71.5	30.0
2008	-45.3	-40.7
2007	21.2	9.0
2006	13.6	20.1
2005	9.2	9.5
2004	22.1	14.7
2003	79.6	33.1
2002	1.3	-19.9
2001 (inception September 10th)	10.1	3.6

A US dollar invested in Nomad at inception has grown to be worth $4.93, after fees, as of January 1st, 2013, whilst a dollar invested over the same period in the average share, as reflected in the index above, would be worth around $1.71. Put another way, net asset value (i.e. after fees) has compounded at 15.1% per annum, whilst the index has managed 4.9%.

"*Don't just do something, stand there!"*

The White Rabbit, Alice in Wonderland.

All is quiet at Galactic HQ.

Each day Zak and I shuffle in, swop trainers for slippers, pull up a pile of annual reports and set about analysing and re-analysing our investments. Routinely we try to kill our companies (they can be killed!), and we sift prospective investments. This week: a Glaswegian office property (in administration) – running yield 22%, we kid you not; a Thai big box retailer – scaling laws work in Thailand just as they do in

Seattle; and a large pharmaceutical business (whose Chief Executive does not think it worth mentioning a multi-billion dollar acquisition a year after it was made!). The research continues but, as far as purchase or sale transactions in Nomad are concerned, we are inactive. Inactive except, perhaps, for the observation, seldom made, that the decision not to do something is still an active decision; it is just that the accountants don't capture it. We have, broadly, the businesses we want in Nomad and see little advantage to fiddling.

And so it should be. If you did not buy the companies you always wished you had owned when they were on fire sale over the last few years then, when exactly are you going to buy them?

Nomad's businesses, to generalise, are run by founding principals, and the businesses are blessed with cultures that see part of their identity in low operating costs: Costco Wholesale measures costs in basis points and at Amazon.com they take the light bulbs out of the vending machines to save money. In another sphere, the Olympic Team GB Cycling coach and Sky Tour de France Chief (now Sir) Dave Brailsford might refer to this type of behaviour as seeking "*the aggregation of marginal gains*". Just as it leads to gold medals and yellow jerseys, its effect is that AirAsia, for example, is the lowest cost airline in the world. Good things follow when you care about the pennies.

Zak and I have come to appreciate the value in retreating a little from endless stock analysis. From time to time we swap slippers for brogues and head out into the world with the expectation that what we learn through investing helps us in other activities outside the office, and what we learn doing other activities helps us as investors. I have my school turnaround project, Zak has various charity projects and, together with members of his family, has set up a children's activity centre. In this letter I thought I might describe some of these activities.

When we visited Carpetright, a UK carpet retailer, a few years ago we spent the morning with its founder, Lord Harris, discussing his firm and the industry. Lord Harris is a great advocate of watching the pennies. One of his store managers told us that his boss had baulked at the cost of new price tags whenever the shops had a sale. To begin with he made the store managers use both sides of the old price tags, at least this would halve the tag budget, but the real saving came from using the same card with replaceable, reusable numbers. It may seem trivial, but the saving has been in the tens of thousands of pounds. Lord Harris is a wealthy, successful man who does not need to work and so, over lunch, we asked him what still gets him motivated, at the age of 66, "*Oh*", he said "*you should see the academies*".

When schools fail in the UK, and the definition of failure is appallingly low exam results sustained through three annual warnings, oversight of the school is taken away from the local education authority and given to an independent body, in this case Lord Harris' Federation of Academies. Once inside the Federation the school (now called an academy) is free to hire a new head, new governors and set its own employment contracts. In the case of the school I became involved with, all three were necessary, the result being an almost complete turnover in staff and governors. It is brutal, but necessary, in order to change the culture. Gone are protected, high salaried employment, a clock watching mentality, and indifference to the pupils' education,

and instead teachers are provided with bonuses for attendance and improved exam results.

Not that there is a lot of money to go around. The school does not receive the additional funding that may come with a location in inner London (the school is just over the border and classified, unlike some other local schools, as outer London), and the catchment area is not sufficiently poor to warrant aid, but then it is not wealthy either. The effect is that funding per pupil is one of the lowest in South London and, to put the figure in perspective, funding per child is around one third of the school fees paid for private education at nearby London day schools. The comparison is not quite apples to apples as private schools have to fund their property, but quite how the school runs inside its budget is extraordinary. Every penny is watched, and resources are spent on the right things such as rewarding good practice in teachers and funding extra curricular activities. It is amazing to see the result: after five years - and with no more funding than the predecessor school - an exam failure rate of around 85% will, in the near future, become an 85% pass rate (fingers crossed!). It is quite something to witness.

Zak's family's activity centre is an interesting tale. The centre is located in a light industrial building and consists of climbing structures and slides set in a three story netted frame, a restaurant for the parents and separate entertainment rooms for birthday parties. There is little endemically proprietary about the business, real estate is relatively cheap, the climbing frames are easily purchased and, catering is catering. The operation has relatively high fixed costs, which means that incremental revenues appear disproportionately valuable and so centres usually compete on price in the hope of attracting customers. The problem is the supply-side, which periodically gets out of control, as a hopeful newcomer sets up another operation in the same catchment area.

It is tempting in managing such an operation to pay the minimum wage. However, after a short while the family found that the quality of staff improved noticeably if, Costco–like, they paid a bit more. Instead of employing relatively young, unskilled (shop) assistants, the centre began attracting people with experience of working with young children, such as nursery school assistants, who cared about the children. The centre polled customers to find out who had made the decision to visit. Contrary to expectations it wasn't child nagging that forced a decision, but parents wanting something to do with (out!) the kids. What parents care about is cleanliness, new fittings and a decent cup of coffee, so money was spent on these items, not on wowing the children with the newest slide. The activities were keenly priced but the centre found that customers responded more to relative prices and so rates were kept just under those of the competition, rather than ruinously low.

At the end of the first year the centre was running at a loss, but one of the competing centres had closed down. Last year the business was breakeven and, just recently, after the demise of a second competitor (with sizeable debts and which had, interestingly, been run by hired hands and not the proprietor) revenues have jumped by a quarter and the activity centre is now earning proper profits.

It is tempting for Zak's relatives to think the battle has been won and, in line with many a business school case study, now gently raise prices to earn a monopolist's

rent. However, Zak's advice to his relatives is counter-intuitive: take prices down (he is a hard man to have on your board). The risk with super-normal profitability is that the profits are an incentive for a new competitor: far better, Zak argues, to earn less, but for a much longer time. This is tough advice for the family members who have been cleaning loos and hoovering floors at eight o'clock at night, but the long-term logic is undeniable. To their very great credit the family are once again lowering prices just a little.

Zak's family's activity centre beat the competition because they understood the difference between good costs (nice staff, clean loos, good coffee) and bad costs (a whizzo new slide) and invested appropriately. They were smart enough to poll customers and observe the influence of pricing (there was no need to over-discount). The operation was equity funded, and did not include a third party in the capital structure (bank debt). But most of all it was founder managed and they cared. Watching the pennies and investing carefully has lead to the "*aggregation of marginal gains*" and financial success, and as such it has much in common with the investments that populate Nomad. It has been fun for Zak and I to practice in the real world, what we preach in investing.

Not that we get it right all the time. The agent behind the high yielding Glaswegian office property told us that he had just re-let his first building, twenty-five years later.

"*The rent then was £4.26 per foot, it was never going to sell for a round number because both parties cared about the pennies. I have just re-let it for £42 per foot, a round number. You only ever deal in round numbers these days. People don't care about the pennies anymore, that's why no one has got any money*," he told us.

Zak and I spend all our time thinking about good business practices and we greatly admire firms that watch the pennies but we looked at our shoes as we were told this story - the rent at Galactic HQ is…ahem…I will whisper this…a round number.

We still have much to learn.

Housekeeping.

Earlier this month Phoenix Financial Services in Dublin, Nomad's administrator, announced that they have agreed to a management buy-out from the Phoenix Group. Phoenix Dublin's CEO, Gavin Gray, and his team have done a first rate job for Nomad's partners over the years. Zak and I, and Nomad's independent directors wish, indeed, Gavin and his team deserve, every success in the future. The transaction, which is subject to regulatory approval, will result in Nomad rising from approximately one-quarter of group revenues, to around three-quarters of the new (MBO) firm's revenues. Gavin does not want it to stay that way, and will look to grow his new firm free from the demands of a parent company (sound familiar?). Zak and I, and Nomad's independent directors, support the idea of Nomad's administrator being owner managed (normally terrific for service quality) and hope that Nomad's future good performance will stop our proportionate share of Gavin's business from falling too fast! I don't think it is a fair race, Gavin is far too good an administrator to remain small for long. We wish them all the best.

As always, thank you for your quiet, gentle hand on the tiller. It is important to Zak and me to be in an ecosystem that gives us the mental freedom to think rationally and avoid the psychological pitfalls that pepper the industry. Do not underestimate the important role you play in maintaining a healthy ecosystem.

We wish you a very Happy New Year,

Nicholas Sleep

Our footnotes

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Nomad Investment Partnership

Interim Letter

For the period ended June 30th, 2012.

Cumulative results to June 30th, 2012.	Nomad Investment Partnership	MSCI World Index (net) US$
Trailing:		
One year	-5.4%	-5.0%
Two years	64.2	24.0
Three years	126.8	36.6
Four years	89.5	-3.7
Five years	55.0	-13.9
Six years	100.7	6.8
Seven years	121.1	24.4
Eight years	179.2	36.9
Nine years	293.7	69.8
Ten years	384.2	65.6
Since inception (Sept 10th 2001)	455.2	56.5
Annualized since inception:		
Before performance fees	17.2%	4.2%
After performance fees	15.1	
Value of a dollar invested at inception (pre-fees)	$5.55	$1.56

The figures above are unaudited, presented on a cumulative, percentage gain basis and, as ever, are before fees. We present results in this way as Nomad's refundable performance fee and time dependent performance fee hurdle mean that the net-of-all-fees results will vary with subscription date, and from investor to investor. Partners will, therefore, each have their own, unique, net-of-all fees experience of investing in Nomad. As a guide, we have also detailed the net-of-all-fees results from one point in time, in this case since inception. An index is used in the table to place our results in context with a broad swathe of share prices from around the world. One of the reasons that Nomad is Nomad is that Zak and I spend almost no time thinking about stock market indices. We do not feel strongly about the merits, or otherwise, of this particular index and we would encourage partners to employ another if they feel it is more appropriate. Whatever the yardstick, we ask only that Nomad be compared over the very long-term. Below, the same pre-fee results are presented in discrete annual increments. In our opinion, it is probably the upper table that is most useful in assessing long-term investment performance.

Calendar Year Results:	Nomad Investment Partnership	MSCI World Index (net) US$
2012 year to date	23.3	5.9
2011	-9.9	-5.5
2010	43.9	11.8
2009	71.5	30.0
2008	-45.3	-40.7
2007	21.2	9.0
2006	13.6	20.1
2005	9.2	9.5
2004	22.1	14.7
2003	79.6	33.1
2002	1.3	-19.9
2001 (inception Sept 10th 2001)	10.1	3.6

A US dollar invested in Nomad on September 10th 2001, when Zak and I began managing the Partnership, has grown to be worth $5.55 before fees, as of June 30th, whilst a dollar invested over the same period in the average share, as reflected in the index above, would be worth around $1.56. Put a slightly different way, net asset value (i.e. after fees) has compounded at 15.1% per annum, whilst the index has managed 4.2%.

Information as Food.

The castaway for the seventieth anniversary edition of BBC Radio 4's Desert Island Discs was the naturalist, David Attenborough. Kirsty Young, the host, introduced David Attenborough as follows:

Kirsty Young: *"He has seen more of the world than any person who has ever lived. The depth of his knowledge and breadth of his enthusiasm have had a fundamental affect on how we view our planet. From sitting hugger-mugger with the mountain gorillas of Rwanda, to describing the fragilities of the flightless Kakapo: the wonders*

of the natural world are his stock-in-trade. His passion can be traced right back to the days as a lad when he cycled his bike through the Leicestershire countryside trawling for fossils. He says he knows of no deeper pleasure than the contemplation of the natural world. David Attenborough, you visited the North and South Poles, you witnessed all of life in-between from the canopies of the tropical rainforest to giant earthworms in Australia, it must be true, must it not, and it is a quite staggering thought, that you have seen more of the world than anybody else who has ever lived?"

David Attenborough: *"Well…I suppose so…but then on the other hand it is fairly salutary to remember that perhaps the greatest naturalist that ever lived and had more affect on our thinking than anybody, Charles Darwin, only spent four years travelling and the rest of the time thinking."*

Oh!

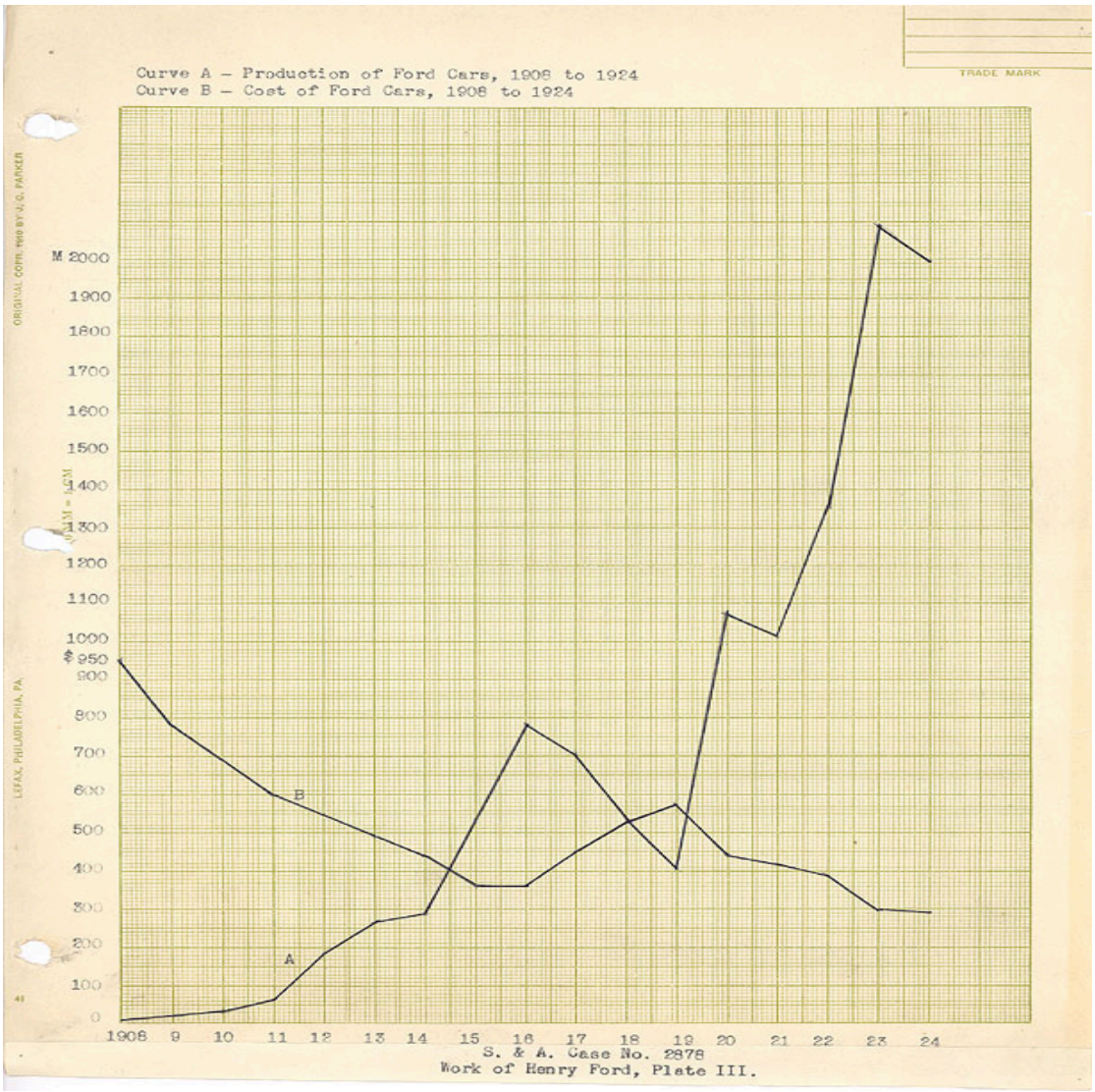
David Attenborough's modesty is delightful but notice also, if you will, the model of behaviour he observed in Charles Darwin: study intensely, go away, and really think. It is Darwin, he argues, who has contributed more. In other words, Attenborough is saying that the human mind trumps endless data collection. We could be more specific: the frontal cortex of the brain, which is charged with rational thought and information processing, can make more sense of the world, given enough time to think it through, than the senses themselves can make sense of the world.

In today's information soaked world there may be stock market professionals who would argue that constant data collection is the job. Indeed it could be tempting to conclude that today there is so much data to collect and so much change to observe that we hardly have time to think at all. Some market practitioners may even concur with John Kearon, CEO of Brainjuicer (a market research firm), who makes the serious point, "*we think far less than we think we think*" - so don't fool yourself!

Whilst Zak and I applaud John Kearnon, we try to take Charles Darwin's approach: de-emphasise the data collection and think. When we study truly great businesses we find that very often it has been simple human attributes that have lead to their success: you feel differently drinking a Coke than a no brand cola or, you may feel differently towards a business that consistently undercuts the competition in price or, a delivery service that literally goes the extra mile and picks up returned items – and the reason you have these feelings, and the stimuli that produce them, have hardly changed in millennia. When we try to understand the factors that made great businesses great, in our opinion, there is lots of time to think.

For example, it is interesting to note that the business model that built the Ford empire a hundred years ago and is illustrated in the chart below (dated 1927), is the same that built Sam Walton's (Wal-Mart) in the 1970s, Herb Kelleher's (Southwest Airlines) in the 1990s or Jeff Bezos's (Amazon.com) today. And it will build empires in the future too. The longevity of the model is not difficult to understand as Jeff Bezos pointed out "*I can't imagine that in ten years from now customers are going to say: I really love Amazon, but I wish their prices were a little higher*"…or Amazon was less convenient, or they had less selection.

Chart 1: Production Volumes and Cost (to the consumer) of Ford Cars 1908 to 1924.



Source: The original 1927 report of the Franklin Institute of the State of Pennsylvania for the Promotion of the Mechanical Arts, recommending "Mr. Henry Ford, of Detroit, Michigan" for the Institute's Elliott Cresson Medal. Line A illustrates the volumes of cars produced, in this case from zero to just over two million per annum. Line B describes the decline in cost (probably to the consumer) of the Model T Ford from U$950 to around U$300. The x-axis refers to the calendar years 1908 to 1924.

Whilst the basic business models that lead to success don't change that much and there aren't that many of them, there is still all that data to deal with. So, how should we think about information?

The journalist and technologist, JP Rangaswami, argues that the most helpful way to think about information is the same way we think about food. His analogy may even have some scientific grounding. In the "Expensive Tissue Hypothesis" anthropologists Leslie Aiello and Peter Wheeler state that for a given body size a primate's metabolic rate is relatively static, what differs from primate to primate is the balance of tissues, most notably the tissues that are expensive to operate, principally the nervous system (including the brain) and the digestive system. In man we have small stomachs and large brains, in pigs the opposite is true. If you want a larger brain

you have to live with a smaller gut, and of course the large brain provides the thinking power to organise the world in such a way that one is not required to constantly graze.

Leaving the science aside, Rangaswami's analogy is wonderfully provocative: in the cultivation of food there are hunter gatherers who are free to roam, or farmers who put up fences to define ownership; the same is true in information, is this not what patent and copyright law is all about? In the preparation of food we can either choose distilled nutrition (a beef steak, for example) or a smorgasbord that allows for the mixing of raw nutrients; the same is true when we are served with a conclusion or instead ask for the underlying data.

And then there are the differences, for instance information does not always have food-like quality standards. There is little-to-no labelling of information presented on television, so fact and fiction can be deliberately fused and have given rise to "docudramas" and "mocumentaries". In literature the same phenomenon exits and has been popularised following the success of books such as Dan Brown's "The Da Vinci Code". To avoid confusion, one solution may be to label information for its fact content, in the same way we label food for its fat content.

And what of the implications of over-consuming? Clay Shirky, the writer and internet consultant, claimed that "*there is no such animal as information overload, only filter failure*" which, using Rangaswami's analogy, implies we need to think about data diets and information exercise to prevent the build up of toxins and disease. "*When I saw* [Morgan Spurlock's documentary film] *'Super Size Me'"* joked Rangaswami in a recent speech "*I started thinking, now what would happen if an individual had thirty-one days nonstop Fox News?*" What, indeed?

Information, like food, has a sell by date, after all, next quarter's earnings are worthless after next quarter. And it is for this reason that the information that Zak and I weigh most heavily in thinking about a firm is that which has the longest shelf life, with the highest weighting going to information that is almost axiomatic: it is, in our opinion, the most valuable information. No doubt Charles Darwin would agree.

Our Management Fee.

Nomad's cost-reimbursement management fee (Zak and I meet the costs of running the operation each month and are reimbursed at the beginning of the following month) will have an annual run rate of fewer than ten basis points in the near future. We may not quite get there this year, but we are going in that direction. Our management fee was a philosophical decision for us. We thought that in managing the Partnership we had not added value per se, and so the management fee should meet the Partnership's costs, but not be a source of profit. A by-product of this is that as the Partnership grows in size the management fee declines as a percentage of assets, and so the incremental dollar brings something to the party, as it were. In the last six years the management fee has fallen from circa fifty basis points to close to ten, and with little scrimping of costs: Zak's and my salaries have normalised after several years of being in family-holdback-start-up mode, we travel all we need, we purchase the research resources we value, and the rent has just gone up. The saving to our partners, who are mainly charities and endowments for charitable causes, is not trivial: approximately U$15m per annum compared to the industry standard one percent management fee, or

over U$30m per annum compared to the hedge fund standard. We mention this to pop the illusion that investment management is a Giffen good (one where, paradoxically, demand rises with price). Indeed, Zak and I would take it a step further and say that incentives (and rules) can de-moralise behaviour, and what the industry needs more than anything, perhaps, is a sense of right and wrong. It can be hard to separate right from wrong when there is so much money sloshing around. It is a contentious thought but, if one could lower management fees across our peer group, one may end up improving aggregate industry behaviour in the process!

Housekeeping

In March this year we registered as an Exempt Reporting Advisor with the Securities and Exchange Commission. Also earlier in the year Martin Byrne, who has been an independent director of Nomad since its formation, announced his semi-retirement and so resigned as a director. As Martin's firm housed the Partnership's registered office that has also moved (to: 1st floor, Landmark Square, 64 Earth Close, P.O. Box 715, KY1-1107, Grand Cayman, Cayman Islands). Martin has been excellent council over the years, and he knows we wish him well. His replacement is Ralph Woodford, a British Caymanian, former fund manager with Edinburgh Fund Managers and a private banker for Coutts. And of course, he knows we welcome him too.

Lastly, thank you for your patience and the trust implied in continued subscriptions. The last time we wrote to you announcing Nomad's reopening was in October 2008, in the pit of the stock market cycle and, with the exception of a few hardy types who subscribed, you could have heard a pin drop! We had that experience in mind when we decided to reopen in the New Year, but this time demand was such that within two weeks we had to close again – quite a contrast! Zak and I do not like being open, and we are happy with our hermit-like state, minding our own business and getting the job done. Nomad is also of such a size that we may risk storing up problems for the future should we grow too large. We do not think we are navigating those waters yet but we keep an eye out for rocks nonetheless.

As always, we thank you for your gentle approach,

Yours sincerely

Nicholas Sleep

Our Footnotes

There is, we are told, a ticket kiosk at a railway station somewhere in India with a sign above the window that reads, "*No Bamboozlement Here*". It is in the same spirit that we attempt these cautionary words. Disclaimers boil down to the following statement – if you choose to believe any of this, then you are on your own. Yikes! It will be hard for us to escape this conclusion too, and it makes little sense for us to do anything but disclaim liability for errors, omissions and offer no warranties – please, check everything we say, let us know when we are wrong and forgive our errors. We do promise you this: we are human, we make mistakes, but our mistakes are honest ones. Although we do not intend to

mislead, we also cannot guarantee the information in these letters, or that some of our ideas may be interpreted in ways we do not intend. As investors we are trying to do as good a job as we can and we write these letters in good faith to inform and educate partners on our actions and thinking in the context of the Partnership. We hope that they will be read in the same spirit in which they are written.

Common sense tells you that the price and value of shares can vary greatly, and whilst we do not aim for this, we also recognize that permanent impairment of capital is possible. Our Partnership is concentrated in relatively few investments, perhaps more concentrated than many others, and as such our results will be more volatile than many of our peers. Nomad is also a very long-term Partnership. We do not think it is suitable for investors with time frames less than five years. We also do not think Nomad is suitable for investors overly conflicted with principal-agent issues. If you are at all uncomfortable then, we suspect, Nomad is not for you.

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Some Notes on Housekeeping (stay awake at the back!)

This is the interim letter and, combined with the annual letter sent to investors in January, is the main format we use to communicate to our partners. In these letters we have tried to honestly and thoroughly provide all the information we would seek if the tables were turned and we were investors in someone else's fund. We own shares for very long periods and we are conscious that more frequent or detailed reporting may be unnecessary and even counterproductive. A copy of our magnum opus, the full Collection of Letters, is available upon request from Amanda at Galactic HQ (amanda@sleepzakaria.co.uk). Lots of coffee required. Partners in Nomad will also receive a full copy of our Schedule of Investments by separate post, every six months, which lists all of our investments in detail. In addition, in the Spring you will receive Nomad's annual accounts, audited by Grant Thornton. Each month statements of account are sent to you by Nomad's administrator (not us!), Phoenix Financial Services in Dublin, Ireland. Please call Gavin Gray and his team (+353 18 450 8161) with your statement queries. As should taxable US investors as Gavin and his team prepare their tax certificates (1099s) as well.

Partners should always consider Zak and me to be available at the end of the phone and our (somewhat shabby) front door open to visitors. And whilst we welcome your company, please don't be too disappointed if we don't have much that is new to say: we hope it is in the letters already.

Legal Footnotes

Performance numbers are produced by Phoenix Fund Services, Nomad's administrator, and are audited by Grant Thornton in their annual audit, which follows publication of our letters.

In our letters we refer to both limited partners in the Partnership, and common shareholders in the Nomad Investment Company (feeder fund) as "Partners". We do this to convey a relationship we seek in which our investors are partners in a shared experience and destiny, in which they too have something to contribute. We do not mean to suggest that there is a partnership, in the strict, legal, sense of the word, between the shareholders in the feeder fund and Nomad, or Sleep, Zakaria and Company, Ltd.

This document is issued by Sleep, Zakaria and Company, Ltd., which is authorized and regulated by the Financial Services Authority (FSA) (No. 451772). This document is only sent to people who have an interest in receiving it, and is not for onward distribution. This communication is being made only to and is directed only at: (a) persons outside the United Kingdom; (b) investment professionals, as defined in Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the "Order"); or (c) high net worth companies, unincorporated associations and partnerships and trustees of high value trusts as described in Article 49(2) (a) and (d) of the Order, and other persons to whom it may otherwise lawfully be communicated, falling within Article 49(1) of the Order.

The Nomad Investment Partnership is not a recognized scheme under the Financial Services and Markets Act 2000 ("FSMA"). Given the nature of Nomad's investor base, recourse to the FSA and the Financial Services Compensation Scheme may be limited.

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Nomad Investment Partnership

Annual Letter

For the period ended December 31st, 2011

To December 31st, 2011:	Nomad Investment Partnership	MSCI World Index (net) US$
Trailing:	%	%
One year	-9.9	-5.5
Two years	29.7	5.7
Three years	122.5	37.3
Four years	21.7	-18.6
Five years	47.5	-11.2
Six years	67.6	6.6
Seven years	83.0	16.7
Eight years	123.4	33.9
Nine years	301.3	78.2
Ten years	306.5	42.8
Since inception (Sept 10th, 2001)	347.6	47.9
Annualized since inception:	%	%
Before performance fees	15.7	3.9
After performance fees	13.6	

The figures above are unaudited, presented on a cumulative, percentage gain basis and, as ever, are before fees. We present results in this way as Nomad's refundable performance fee and time-dependent performance fee hurdle means that the net-of-all-fees results will vary with subscription date and so from investor to investor. Partners will, therefore, each have their own, unique, net-of-all fees experience of investing in Nomad. As a guide, we have also detailed the net-of-all-fees results from one point in time, in this case since inception. An index is used in the table to place our results in context with a broad swathe of share prices from around the world. We do not feel strongly about the merits of the index we have chosen, and partners may wish to use another. Whatever the yardstick, we ask only that Nomad be compared over the very long-term. Below, the same pre-fee results are presented in discrete annual increments. In our opinion, however, it is probably the table overleaf that is most useful in assessing long-term investment performance.

To December 31st:	Nomad Investment Partnership	MSCI World Index (net) US$
Calendar Year Results:	%	%
2011	-9.9	-5.5
2010	43.9	11.8
2009	71.5	30.0
2008	-45.3	-40.7
2007	21.2	9.0
2006	13.6	20.1
2005	9.2	9.5
2004	22.1	14.7
2003	79.6	33.1
2002	1.3	-19.9
2001 (inception Sept 10th, 2001)	10.1	3.6

A US dollar invested in Nomad at inception has grown to be worth $3.71, after fees, as of January 1st, 2012, whilst a dollar invested over the same period in the average share, as reflected in the index above, would be worth around $1.48. Put another way, net asset value (i.e. after fees) has compounded at 13.6% per annum, whilst the index has managed 3.9%.

As a young(er) investment analyst, I once met with the CFO of a large US West Coast bank. I was anxious beforehand, it is not easy for a young man to hold his own with a senior executive of any business, let alone one as opaque as a bank. I forget which question I asked, no doubt it was cloaked in the latest management buzzwords of the day but, at any rate, it was so overly complicated that it elicited the following response,

"*Look, son, at the end of the day it is all about cash-in, and cash-out*".

Oh dear! Well, the put down could have been worse, and probably deserved to be worse. That was a lesson learnt: keep it simple, it is all about cash-in, and cash-out.

Zak and I run a single partnership that has long-term investments in the shares of, for all that matters, ten companies, all paid for with cash. We own the investment advisor

that manages the partnership and, ordinarily, we are closed to incremental subscriptions and so free of marketing obligations. That's it. It is terribly, terribly simple, but it is not easy. It is not easy because there are so many distractions: news items, the soap opera of the stock market, macro economic events, politics, currencies, interest rates, principal/agent temptations, regulation, compliance, administration and so on - this list is not exhaustive! It is all too easy to make things more complicated than they need to be or, to invert, it is not easy to maintain discipline. One trick that Zak and I use when sieving the data that passes over our desks is to ask the question: does any of this make a meaningful difference to the relationship our businesses have with their customers? This bond (or not!) between customers and companies is one of the most important factors in determining long-term business success. Recognising this can be very helpful to the long-term investor.

For example, what investors needed to understand, and attribute sufficient weight to, in order to hold Colgate-Palmolive shares for the last thirty years, and so enjoy the fifty-fold uplift in share price, was the economics of incremental products (often referred to as "line extensions", from the first "Winterfresh" blue minty gel in 1981 to "Total Advanced Whitening" today) and the psychology of advertising. Other items were important too, discipline in capital spending in particular, and there were lots of other things that seemed important along the way (stock market crises, country crises, management crises and so on) but it was the success and economics of line extensions and advertising that, in our opinion, was what the long-term investor really needed to embrace. A similar story can be told at Nike and Coca-Cola (manufacturing savings funnelled into dominant advertising) or Wal-Mart and Costco (scale savings shared with the customer). Recognising and correctly weighing this information in-spite of the latest news flow is a matter of discipline, and it is that discipline that is so richly rewarded in the end.

The simple deep reality for many of our firms is the virtuous spiral established when companies keep costs down, margins low and in doing so share their growing scale with their customers. In the long run this will be more important in determining the destination for our firms than the distractions of the day. Jeff Bezos, founder of Amazon, made the following point in a recent interview in Wired magazine:

"There are two ways to build a successful company. One is to work very, very hard to convince customers to pay high margins [the Colgate, Nike, Coca-Cola model alluded to above]. *The other is to work very, very hard to be able to offer customers low margins* [the Wal-Mart, Costco, AirAsia, Amazon, Asos model]. *They both work. We're firmly in the second camp. It's difficult – you have to eliminate defects and be very efficient. But it's also a point of view. We'd rather have a very large customer base and low margins than a small customer base and higher margins."*

Although Mr Bezos does not mention it, one reason he prefers Amazon to be a large company with small margins is that if he shares the efficiency benefits that come with growth with his customers, he turns size, frequently an anchor on business performance, into an asset. In other words, the moat surrounding the firm deepens as the firm grows. So, having shared low costs with their customers, how are our firms' relationships with their customers going? One way to look at this is revenue growth. The weighted average revenue growth of Nomad's firms is currently over thirty percent per annum. Note: this is organic growth with, if anything, falling prices and

no acquisitions in a time of austerity and little economic growth. It would appear to us that the company – customer relationship is in rude health. That's the cash-in. And the cash-out? Keeping it simple again: return on capital at Nomad's firms is over twice that of competing businesses.

The real risks are not those in the newspapers.

It is not that the garden will always be rosy. There are lots of ways that our firms could drain the moats that surround them. One example might be wide-scale credit card fraud following the loss of customer information (perhaps say after a careless employee left a lap top in a taxi). Yikes! If the neglectful firm made light of the situation, pretending it was a small loss and no harm was done, then they had better be telling the truth. Making light of a far more serious situation, perhaps as News International may be finding out today, risks breaking even a long-standing bond of trust. So, in our opinion, it wont be the on-line fraud, per se, or, heaven forbid, an airplane crash at AirAsia, that could ruin our firms, but a disingenuous response to a problem.

One of the lovely aspects of human nature is the ability to forgive. If, for example in our hypothetical on-line fraud situation, the firm comes clean, is candid in explaining the problem, learns its lesson, makes good on the losses and say, puts twenty dollars into each of its customer's accounts, or buys them chocolates or roses, then the long-term relationship with the customers has probably not been harmed too much and, if done properly, may even have been enhanced. When we asked the founder of AirAsia what would he do if his firm put a plane in a swamp (!), he raised both hands in a gesture of having nothing to hide. That response strikes us as very healthy.

Indeed a greater risk to our businesses may come as a by-product of success – be it bubble valuations in the stock market and/or, political risk in the form of anti-trust like pressures. For example, as retailing moves increasingly on-line what is the probability of an on-line retailing tax? Or an on-line retailing tax that is higher than VAT or GST? This is conjecture, of course, but we mention this to illustrate that the long-term risks our companies face are not those that dominate the newspapers and headlines today (credit crises, housing crises, budget crises, Euro crises and so on) but those events that could prevent them from reaching their potential. It is these risks that Zak and I try to identify and understand.

Black Arrow and Accounting

Eagle-eyed investors may have noticed that Black Arrow Group plc, a firm valued at nil in the Partnership, has recently declared a dividend of one pence per share. A one-penny dividend from a worthless holding means that, in accounting terms, we have created money out of nothing! The Alchemists were not that good, so what has been going on? Black Arrow was founded and continues to be run by the octogenarian Arnold brothers, who own or control around eighty-eight percent of the shares outstanding. The shares were de-listed from AIM (a UK stock exchange) in February 2010. At the time, book value approximated one pound per share, although the last traded share price was fifty-two pence. There is no market for the shares, and no prospect of a market for the shares as the brothers do not wish to own more (we have tried), and so the investment has been valued at nil in the Partnership (with a paper

loss of around one tenth of one percent of net asset value). Zak and I know the business is troubled but it is also not worth nothing; then again to assign a positive value would be just as arbitrary as we could not give you cash for your shares either - so zero it is. Almost all valuations are wrong, in effect, and in the case of Black Arrow, although de-listed and in poor health, the firm has continued to operate with the resultant one pence dividend. Enjoy it whilst it lasts. We remain hopeful, but not optimistic, that the dividend alchemy will continue.

Accountants

Nomad has had the same accountants for eleven years. As with many outsourced relationships the quality of service has a tendency to decline with the passing of time, even as the price charged rises with the years. In the end the rubber snaps, and we have recently appointed a senior partner at a new accounting firm for approximately two-thirds of the money we were paying for the services of the old accounting firm. You should expect the Nomad accounts to be with you in late March as usual and, as we have retained the incumbent accountant for the US and UK tax filings, these should also run as normal.

A Word on Education

Readers may recall that a few years ago I became involved in a failed school in South East London. Academic standards at the school had slipped to the point that the government had taken back control of the school from the local education authority and handed its running to an independent foundation. The school's new status as an "academy" has allowed it to be governed relatively free from constraints and with the result that, now in its fourth year, the eighty-five percent exam failure rate that was inherited, will soon be turned into a eighty-five percent pass rate. The UK school inspectorate recently awarded the school an "outstanding" rating. I don't think they knew what to do with me as a governor, and so I was put in charge of the finance committee (type-cast again). From this vantage point I can see that the turnaround has been achieved with no extra funding – the school's revenues this year match that of its failed predecessor. It can be tempting to think that more money is the answer to problems but it strikes us that it is not the money you have, but the choices you make, that count.

Keep your eyes on the horizon.

It is not the easiest time to be an equity investor. The factors that have lead to the devaluation of equities relative to almost all other investment possibilities (perhaps with the exception of housing) have little to do with how well companies have been managed. Be that as it may, Nomad's firms are, on average, so cost advantaged compared to many of their competitors that the worse it gets for the economy, the better it gets for our firms from a competitive position. The trick to being a good investor, over the long-term, is to maintain your long-term oriented discipline. Bezos again:

"Our first shareholder letter, in 1997, was entitled, "It's all about the long-term". If everything you do needs to work on a three-year time horizon, then you're competing against a lot of people. But if you are willing to invest on a seven-year time horizon,

you're now competing against a fraction of those people, because very few companies are willing to do that. Just by lengthening the time horizon, you can engage in endeavours that you could never otherwise pursue. At Amazon we like things to work in five to seven years. We're willing to plant seeds, let them grow – and we're very stubborn. We say we are stubborn on the vision and flexible on the details".

The uniqueness of Nomad's ecosystem is the look-through consistency of approach of its participants, from Mr Bezos and the good folks that run Nomad's other businesses, to Zak and me and on to our investing partners. We are all choosing to see the world in the same way. It is very simple and, because it is the road-less-travelled, it is also very valuable, but it is not always easy. Please, never underestimate the importance of your role in the ecosystem. It is for that reason we named Nomad a Partnership, not a fund.

We wish you a very Happy New Year

Yours sincerely

Nicholas Sleep

Our footnotes

There is, we are told, a ticket kiosk at a railway station somewhere in India with a sign above the window that reads, "*No Bamboozlement Here*". It is in the same spirit that we attempt these cautionary words. Disclaimers boil down to the following statement – if you choose to believe any of this, then you are on your own. Yikes! It will be hard for us to escape this conclusion too, and it makes little sense for us to do anything but disclaim liability for errors, omissions and offer no warranties – please, check everything we say, let us know when we are wrong and forgive our errors. We do promise you this: we are human, we make mistakes, but our mistakes are honest ones. Although we do not intend to mislead, we also cannot guarantee the information in these letters, or that some of our ideas may be interpreted in ways we do not intend. As investors we are trying to do as good a job as we can and we write these letters in good faith to inform and educate partners on our actions and thinking in the context of the Partnership. We hope that they will be read in the same spirit in which they are written.

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This document is issued by Sleep, Zakaria and Company, Ltd., which is authorized and regulated by the Financial Services Authority (FSA) (No. 451772). This document is only sent to people who have an interest in receiving it, and is not for onward distribution. This communication is being made only to and is directed only at: (a) persons outside the United Kingdom; (b) investment professionals, as defined in Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the "Order"); or (c) high net worth companies, unincorporated associations and partnerships and trustees of high value trusts as described in Article 49(2) (a) and (d) of the Order, and other persons to whom it may otherwise lawfully be communicated, falling within Article 49(1) of the Order.

The Nomad Investment Partnership is not a recognized scheme under the Financial Services and Markets Act 2000 ("FSMA"). Given the nature of Nomad's investor base, recourse to the FSA and the Financial Services Compensation Scheme may be limited.

Sleep, Zakaria and Company, Ltd.

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Nomad Investment Partnership

Interim Letter

For the period ended June 30th, 2011.

Cumulative results to June 30th, 2011.	Nomad Investment Partnership	MSCI World Index (net) US$
Trailing:		
One year	73.7%	30.5%
Two years	139.9	43.8
Three years	100.5	1.4
Four years	64.0	-9.4
Five years	112.5	12.4
Six years	134.0	30.9
Seven years	195.3	44.1
Eight years	316.6	78.7
Nine years	412.5	74.3
Since inception (Sept 10th 2001)	487.5	64.7
Annualized since inception		
Before performance fees	20.9%	5.5%
After performance fees	17.7	
Value of a dollar invested at inception (pre fees)	$5.87	$1.65

The figures above are unaudited, presented on a cumulative, percentage gain basis and, as ever, are before fees. We present results in this way as Nomad's refundable performance fee and time dependent performance fee hurdle mean that the net-of-all-fees results will vary with subscription date, and from investor to investor. Partners will, therefore, each have their own, unique, net-of-all fees experience of investing in Nomad. As a guide, we have also detailed the net-of-all-fees results from one point in time, in this case since inception. An index is used in the table to place our results in context with a broad swathe of share prices from around the world. We do not feel strongly about the merits of the index we have chosen, and partners may wish to use another. Whatever the yardstick, we ask only that Nomad be compared over the very long-term. Below, the same pre-fee results are presented in discrete annual increments. In our opinion, it is probably the upper table that is most useful in assessing long-term investment performance.

Calendar Year Results:	Nomad Investment Partnership	MSCI World Index (net) US$
2011 year to date	17.5%	6.3%
2010	43.9	11.8
2009	71.5	30.0
2008	-45.3	-40.7
2007	21.2	9.0
2006	13.6	20.1
2005	9.2	9.5
2004	22.1	14.7
2003	79.6	33.1
2002	1.3	-19.9
2001 (inception Sept 10th 2001)	10.1	3.6

A US dollar invested in Nomad at inception has grown to be worth $5.87 before fees, as of June 30th, whilst a dollar invested over the same period in the average share, as reflected in the index above, would be worth around $1.65. Put a slightly different way, net asset value (i.e. after fees) has compounded at 17.7% per annum, whilst the index has managed 5.5%.

Some observations on mental shortcuts

At Professor Richard Zeckhauser's Behavioural Finance course at the JFK School of Government at Harvard University, the following note was scribbled by Professor Zeckhauser and passed to a fellow panelist, whilst both men hosted a discussion group with an audience of investment professionals.

Zeckhauser: *One of our participants is buying Zimbabwean securities, which are priced at a small percentage of Net Asset Value. Would you try to invest with him?*

Other panelist: *No!* (the exclamation mark is original)

Oh dear! We suspect that the other panelist made up his mind the moment he saw the word Zimbabwe and that blocked his thinking of the gain that could be made from such low prices. We all do this to some extent. It is so easy to screen out a good idea because of a bad association. As Charlie Munger quipped at a speech given at the same course a few years earlier "*the human mind is a lot like the human egg*": once one sperm has entered then all the other sperm are locked out. A market research company we visited recently told us that most car advertising is read after the purchase decision for the car has already been made! And it was read only then to gather information to convince other people the purchase decision was rational *("no, no it wasn't the car's sexy shape – this car has twelve airbags and emits 170g of carbon per mile!")* We have all done it. The human mind has these learnt biases, short cuts, fears, habits, and associations and, in the case of the panelist above, they can stop us from making rational decisions.

An odd question popped into our heads the other day: why are internet retailers growing so slowly? Unlike traditional retailing, where growth is bounded by the physical constraints of a building's size, location, and opening hours, internet retailing has no such constraints. We could all, for the sake of argument, decide to do all our shopping online next week, and Amazon et al would take the orders. Odd, then, that the growth rate in revenues at the main internet based retailers is, very broadly, comparable to that enjoyed by a physically constrained retailer, say, Wal-Mart, at a similar stage in its development. So what is going on?

If Frank Capra is right that "*a hunch is creativity trying to tell you something*" then our hunch is that the growth rate in online retailing is held back by consumers' psychological biases. We are all creatures of habit, and most of us give up comfort blankets quite reluctantly. It therefore takes time for a new regime to be adopted and, for instance, to buy books online instead of buying them at the local store. Perhaps then, after we have become comfortable with buying books online, we may experiment with something else, trainers say, or magazine subscriptions, or plant pots, or bike saddles or grocery. The process requires a good retail experience (price, convenience, selection etc.), the building of trust, and is often fanned with personal recommendations (social proof) and even bragging rights for the early adopters. The process is more of a drift than epiphany. Our hunch is that the growth rate in online retailing is regulated, not by physical capacity, although that can be a limiting factor, but more by the rate at which our own incumbent habits and associations are replaced with more rational behaviour.

<u>The models we use may not be the right ones</u>

In high street retailing we can estimate, broadly, what revenue growth for each firm will be next year: it is a product of same store sales growth plus any new stores. We might not be precisely correct about either number, but the range is bounded and so we can make a reasonable, "*generally-right*" (as opposed to "*precisely wrong*") estimate. When investors think about the future of a business, they often have in mind the assumption that growth rates slow with time, as competition ekes away advantages and market places become saturated. Predicted revenue growth rates (used in valuation models) therefore start high and end low. This is especially true for firms that are quite large already.

However, if the rate of growth in internet retailing is a product of attitude, rather than assets, then, the fact that a firm is quite large already does not necessarily tell you that its growth rate is set to slow. The widely held presumption that regression to the mean begins the moment the analyst picks up their pen, risks being wrong footed as a result. Two years of forty percent revenue growth, for example, will result in revenues doubling in twenty-four months and regression to the mean based estimates would be out by almost a factor of two! That did not take long. In other words, although some online retailing firms may be quite large, they may also be quite young. In our opinion, it is this realisation that has partially driven the revaluation of internet retailers these last few years.

More on the principal agent conflict, and the lack of trust…

Whilst Zak and I do enjoy solving the investment problem, as it were, we are less enraptured with the tone of the investment industry, especially the state of industry governance. The rules embedded in regulation, accounting and "due diligence" may be well meaning, and appear justified by past fund managers' rogue behaviour (and our industry has some choice rogues!), but their enforcement and adherence drains the life out of the innocent, and would challenge the patience of Job. Just as sapping is that it is impossible for practitioners to earn their way out of over-bearing governance through good behaviour. Trust, once the cornerstone of the industry and derivation of words such as unit trust, investment trust, trustee and so on, has been all but lost. It is a great shame.

The cynicism may be endemic, but it is no substitute for wisdom. We enjoyed the following paraphrased exchange related to us by one of the fund management industry's stars of a conversation he had had with an analyst:

Analyst: *your performance is without peer in recent times, but if you did not own company x and company y over the last few years your performance would have been only average.*

Star fund manager: *but that's the point, I did!*

The spirit in which the industry conducts its affairs is not always mankind at its best, and sometimes it does not bring out the best in people. What is required, in our opinion, is the rebuilding of a web of deserved trust between participants. We hope that the Nomad model, with its patience, reciprocated trust, and calm, is a small step in the right direction. It is rather wonderful that it is also a financially profitable way to behave.

There is a lot to celebrate.

There is a lot to celebrate at Galactic HQ. It might be that the weather has turned, it might be the bumper honey harvest from the bees on HQ roof (I kid you not, ask Zak), it might be Nomad's performance (but I don't think so). In the next few months we have lots to be grateful for: we celebrate five years of Sleep, Zakaria and Company, ten years since Nomad's formation and twenty years for each of us in the industry. We are grateful to be here, and we recognise that our genesis was pretty unique (thank

you, Jeremy). We also have a pretty special group of investors: thank you for the trusting and wise role you play in the Nomad ecosystem. We shall raise a glass (of honey tea!) to you all when the crop is in.

Yours sincerely

Nicholas Sleep

Our Footnotes

There is, we are told, a ticket kiosk at a railway station somewhere in India with a sign above the window that reads, "*No Bamboozlement Here*". It is in the same spirit that we attempt these cautionary words. Disclaimers boil down to the following statement – if you choose to believe any of this, then you are on your own. Yikes! It will be hard for us to escape this conclusion too, and it makes little sense for us to do anything but disclaim liability for errors, omissions and offer no warranties – please, check everything we say, let us know when we are wrong and forgive our errors. We do promise you this: we are human, we make mistakes, but our mistakes are honest ones. Although we do not intend to mislead, we also cannot guarantee the information in these letters, or that some of our ideas may be interpreted in ways we do not intend. As investors we are trying to do as good a job as we can and we write these letters in good faith to inform and educate partners on our actions and thinking in the context of the Partnership. We hope that they will be read in the same spirit in which they are written.

Common sense tells you that the price and value of shares can vary greatly, and whilst we do not aim for this, we also recognize that permanent impairment of capital is possible. Our Partnership is concentrated in relatively few investments, perhaps more concentrated than many others, and as such our results will be more volatile than many of our peers. Nomad is also a very long-term Partnership. We do not think it is suitable for investors with time frames less than five years. We also do not think Nomad is suitable for investors overly conflicted with principal-agent issues. If you are at all uncomfortable then, we suspect, Nomad is not for you.

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Some Notes on Housekeeping (stay awake at the back!)

This is the interim letter and, combined with the annual letter sent to investors in January, is the main format we use to communicate to our partners. In these letters we have tried to honestly and thoroughly provide all the information we would seek if the

tables were turned and we were investors in someone else's fund. We own shares for very long periods and we are conscious that more frequent or detailed reporting may be unnecessary and even counterproductive. A copy of our magnum opus, the full Collection of Letters, is available upon request from Amanda at Galactic HQ (amanda@sleepzakaria.co.uk). Lots of coffee required. Partners in Nomad will also receive a full copy of our Schedule of Investments by separate post, every six months, which lists all of our investments in detail. In addition, in the Spring you will receive Nomad's annual accounts, audited by Ernst and Young. Each month statements of account are sent to you by Nomad's administrator (not us!), Phoenix Financial Services in Dublin, Ireland. Please call Gavin Gray and his team (+353 18 450 8161) with your statement queries. As should taxable US investors as Gavin and his team prepare their tax certificates (1099s) as well.

Partners should always consider Zak and me to be available at the end of the phone and our (somewhat shabby) front door open to visitors. And whilst we welcome your company, please don't be too disappointed if we don't have much that is new to say: we hope it is in the letters already.

Legal Footnotes

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Nomad Investment Partnership

Annual Letter

For the period ended December 31st 2010

To December 31st 2010:	Nomad Investment Partnership	MSCI World Index (net) US$
Trailing:	%	%
One year	43.9	11.8
Two years	146.8	45.3
Three years	35.0	-13.8
Four years	63.6	-6.1
Five years	85.9	12.8
Six years	103.0	23.5
Seven years	147.8	41.7
Eight years	345.1	88.6
Nine years	350.9	51.1
Since inception (Sept 10th 2001)	396.4	56.5
Annualized since inception:	%	%
Before performance fees	18.9	4.9
After performance fees	16.6	

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fees results will vary with subscription date, and from investor to investor. Partners will, therefore, each have their own, unique, net-of-all fees experience of investing in Nomad. As a guide, we have also detailed the net-of-all-fees results from one point in time, in this case since inception. An index is used in the table to place our results in context with a broad swathe of share prices from around the world. We do not feel strongly about the merits of the index we have chosen, and partners may wish to use another. Whatever the yardstick, we ask only that Nomad be compared over the very long-term. Below, the same pre-fee results are presented in discrete annual increments. In our opinion, it is probably the upper table that is most useful in assessing long-term investment performance.

To December 31st:	Nomad Investment Partnership	MSCI World Index (net) US$
Calendar Year Results:	%	%
2010	43.9	11.8
2009	71.5	30.0
2008	-45.3	-40.7
2007	21.2	9.0
2006	13.6	20.1
2005	9.2	9.5
2004	22.1	14.7
2003	79.6	33.1
2002	1.3	-19.9
2001 (inception Sept 10th 2001)	10.1	3.6

A US dollar invested in Nomad at inception has grown to be worth $4.16, after fees, as of January 1st, whilst a dollar invested over the same period in the average share, as reflected in the index above, would be worth around $1.56. Put another way, net asset value (i.e. after fees) has compounded at 16.6% per annum, whilst the index has managed 4.9%.

A note on recent performance: please, please, please mentally take the excesses of the good years and apply them to the deficits of the poorer years. In our opinion, this mental trick will help you, and us, make much more rational decisions. This is because it helps to sidestep the Pavlovian response to a sharp change in prices and to sell apparent winners to buy losers or, indeed, the other way around. Zak and I have no influence over the chronological sequence of good years and bad years and we do not trade around our holdings (the practice of trying to outwit short term share price changes and if it goes up, sell a bit; and if it goes down, buy a bit). However, we do expect, through our analysis, to have some influence over Nomad's destination at the end of a sequence of years. Nomad is about destinations, not smooth routes (no kidding!), and we will have bad years again in the future. Promise. To paraphrase the philosopher William James, the art of being wise is the art of knowing what to overlook. In that spirit, we would suggest you overlook Nomad's short-term results. We do.

The question then arises: what is a reasonable period to assess performance? To this question we have tended to suggest a period of at least five cumulative years, and taking this criteria at its shortest and most recent, Nomad's gain of 13.2% per annum,

all of it earned in the most recent years, is flattered by the paltry alternative 2.4% per annum, offered by the average share. Even this metric may not be that helpful: take that same reading this time last year and the results would show an annual gain of 7.1% for Nomad for the preceding five years (and 2% for the average share). The point is that equity markets have been so volatile that even relatively long-term metrics have been all over the shop. Nomad's first decade has seen a reasonable crop (19% per annum) from passable ground (5% per annum). We have said it before, but you can't say these things too often, you do us a great honour by being a patient and understanding hand on the tiller. Thank you for seeing us through a tricky decade for investors in general.

Thank you, also, to those that subscribed to new redeemable shares in August, and to the new partners, welcome. The incremental funding was relatively small, around ten percent of the Partnership, and marks the end of a period, starting in October 2008, when Nomad has been open to subscriptions. Nomad is now firmly closed to subscriptions and Zak's and my strong preference is for it to remain so. Nomad's size is now such that, with a following wind, management fees will settle toward a single digit basis point over the next few years (and total stockbroker commissions perhaps less than one basis point!). Whilst we love scale economics shared as a business model, it leads you down the wrong path if you run an investment partnership and are also trying to maximise investment returns! Absent a major swoon in the markets, the odds probably go up from here that our next move will be to return capital, rather than seek subscriptions.

There are two main topics that we would like to discuss in this letter. The first is the level of investment spending taking place at our investee firms. In short, it is huge, and, until very recently, quite in contrast to business behaviour at large. Second, the implications of this phenomenon for long-term investors in these businesses. These are important topics and they may be helpful as we think about the evolution of the Partnership over the next few years.

Investment Spending by Nomad's Businesses

One defining characteristic of the annual reports we have read over the last few years has been management's resolve to cut costs. Some of the cost cutting has been wise, some perhaps not so, although time will tell. The effect, however, according to the research boutique Empirical Research Partners, is that, during the last year, the level of free cash flow enjoyed by US companies has been as high a proportion of revenues as at any time since at least the early 1950s. The picture outside the US is similar. This is good news and bad. The "free cash flow yield" that can be earned by equity investors, around 8% of market capitalisation for much of last year, compared favourably with bond yields, and helped underwrite stock prices. However, one man's spending is another man's revenues, and so business activity overall has been depressed. You can't have it both ways, as it were.

That said, over the last few years our investee firms took a different tack. In contrast to business behaviour at large and the intimidating cyclical setting, many of our firms invested heavily. Take, for example, Nomad's internet retailing businesses, which between them account for close to half of the portfolio: at Amazon.com over the last three years, spending on marketing is up threefold and capital investment on new

infrastructure up over fourfold. Note also that these items have grown faster than revenues, which are up two and a half times over the same period. Then there is the subsidy to shipping costs, which have risen threefold, and the continued investment in lowering product prices to the consumer. This investment-in-price-giveback can dwarf other items of investment spending but, by its nature, it is excluded from conventional accounting formats. Its effect, however, can be very real: the saving a consumer would enjoy at Amazon compared to the same basket of goods purchased at a well-run general merchandise chain store will be between approximately 2% and 10% of the total basket price. In other words, Amazon chose to lower revenues by between U$700m and U$3.4bn last year as an investment in hoped-for future customer reciprocation. Including this sum, Amazon will have invested between U$4.8 and U$7.5bn last year, or 14% to 21% of revenues.

It can be argued, quite legitimately, that some of what we have termed "investment spending" here is growth in nature, and some more maintenance (keeping the infrastructure in modern equivalent state). We can all have a guess as to the split between growth and maintenance spending and, if pressed, executives at the firms in question will also have to guess at a split too, as there is no right answer. Even so, we estimate that maintenance spending tends to be a greater proportion of investment spending at high street retailers (all those fixed assets to maintain) or, to invert, there is more genuine growth spending on-line. We would also suggest that investment in price-giveback, so favoured by Nomad's firms, is the most long-lived of the investment spending items if it engenders consumer habit. It may, therefore, be the most valuable to long-term investors. Investment spending like this is a potent force and some internet retailers do it very well. Whatever split one chooses, investment spending at Nomad's firms has been multiples of their high street rivals in recent times.

Internet firms are often sited as having a capital advantage over traditional businesses, in as much as they require fewer assets to generate a dollar in sales than more traditional businesses. The Achilles heel for internet firms has often come in the form of operating costs, which can be hard to manage, especially at the early, sub-scale stages in a firm's development. It was this that destroyed the dot com firms a decade ago. It is interesting to note, therefore, that at the established internet retailing firms today, whose revenues are now sizeable, operating costs as a proportion of revenues are less than some main high street chains. In other words, these firms have a capital cost and an operating cost advantage over their rivals. Amazon, for example, has lower operating costs as a proportion of sales than, wait for it, Wal-Mart, a firm sixteen times its size! It is an awesome combination.

Elsewhere in the Partnership, our firms have also invested during the downturn: Michael Page has kept sub-economic offices open whilst rivals have closed theirs, in an attempt to take permanent market share during the recovery; Costco Wholesale has used the decline in real estate values to increase the rate of site purchases for new stores; at Berkshire Hathaway, Warren Buffett has famously placed his "*all in wager*" on a recovery in the US economy; even at Air Asia, our only sizeable firm to push out its investment plans at all, the delayed delivery of six planes in an order book of one hundred is hardly an indication of real retrenchment.

There are two reasons that our firms have zigged whilst businesses as a whole have zagged. First, Nomad's firms, by and large, have advantages not enjoyed by the incumbent competition and so have not been subject to the same economic imperatives. Second, their cultures are focussed on the customer experience, not on the competition or the profit and loss statement. Our firms tend to chase the vision, not the money.

Before we give the impression that all is rosy in the garden, there is a dark corner of the portfolio, single digit in percentage terms, where the economic reality is troubling. At these firms, revenues continue to decline and, encumbered with debt-funded acquisitions from the last boom, the cost cutting has been aggressive to the point of risking future prospects. These firms may be the last man standing, or near last man standing in their fields, but, absent an upturn in their business conditions, it is very hard for them to earn their way to a higher valuation. In short, it is not clear to us that they are in control of their destination, and that troubles us. If we had our time again, we would hope not to be seduced by their (apparent) mathematical cheapness but weigh more heavily their DNA, if you like. One of the things we have learnt over the last few years is that our most profitable insights have come from recognising the deep reality of some businesses, not from being more contrarian than everyone else. Old habits die hard but, even so, Zak and I are finally attending classes in C.B.A., Cigar Butts Anonymous!

<u>If so, so what?</u>

On a weighted basis, weeds included, Nomad's firms have grown revenues by around thirty percent per annum through the recession. As around two-thirds of Nomad's firms are deploying a scale economics shared approach to their business (increased revenues begets scale savings begets lower costs begets lower prices begets increased revenues) they may have meaningfully widened the moats that surround their firms in the process. It is quite possible that the recession therefore represented a step change improvement in their competitive positions.

Our inclination, whilst the businesses would appear to have so much ahead of them, is to leave well alone. It would be tempting for Zak and I to do high-fives, claim victory, sell our winners and move on to new investments but, we think, that course of action would be fraught with re-investment risk. Be prepared, therefore, for portfolio turnover to be particularly low for a few years, hence our guestimate for brokerage commissions made earlier.

From our perspective, oddly, this can be hard to do. It is hard due to the human itch to be seen to be doing something, perhaps especially when paid a salary to be doing something. Whilst a lack of buying and selling may look from the outside that we are not doing anything (a Sleep at the wheel, as it were…groan!), the decision not to change the portfolio is an active decision and our research continues as ever. Indeed, we find many great businesses available at what seem sensible prices, but, in our opinion, they do not compare favourably with what we already own, and so we move on, constantly comparing what we have with the alternatives, but often, as far as the portfolio is concerned, doing nothing. When I explained this to an old school friend of mine, who was trained to fly fast jets for the British Military, he said – "*Nick, it is really difficult to do nothing, after our training sometimes we would pilot transport*

planes and the instructors would make us physically sit on our hands to force us to think before doing anything". If a UK Top Gun needs to sit on his hands, Zak and I may require straightjackets. Or perhaps a really good read (the new annual report season beckons).

Thank you, as always, for your gentle patience,

We wish you a very Happy New Year,

Nicholas Sleep

Our footnotes

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Some notes on housekeeping (stay awake at the back!)

This is the annual letter and, combined with the interim letter sent to investors in July, is the main format we use to communicate to our Partners. In these letters we have tried to honestly and thoroughly provide all the information we would seek if the tables were turned and we were investors in someone else's fund. We own shares for very long periods and we are conscious that more frequent or detailed reporting may be unnecessary and even counterproductive. A copy of our magnum opus, the full Collection of Letters, is available upon request from Amanda at Galactic HQ (amanda@sleepzakaria.co.uk). Lots of coffee required. Partners in Nomad will also receive a full copy of our Schedule of Investments by separate post, every six months, which lists all of our investments in detail. In addition, in the Spring you will receive Nomad's annual accounts, audited by Ernst and Young. Each month statements of account are sent to you by Nomad's administrator (not us!), Phoenix Financial Services in Dublin, Ireland. Please call Gavin Gray and his team (+353 18 450 8161) with your statement queries. As should taxable US investors as Gavin and his team prepare their tax certificates (1099s) as well.

Clients should always consider Zak and me to be available at the end of the phone, and our (somewhat shabby) front door open to visitors. And whilst we welcome your company, please don't be too disappointed if we don't have much that is new to say: we hope it is in the letters already.

Legal footnotes

Performance numbers are produced by Phoenix Fund Services, Nomad's administrator, and are audited by Ernst and Young in their annual audit, which follows publication of our letters.

In our letters we refer to both limited partners in the Partnership, and common shareholders in the Nomad Investment Company (feeder fund) as "Partners". We do this to convey a relationship we seek in which our investors are partners in a shared experience and destiny, in which they too have something to contribute. We do not mean to suggest that there is a partnership, in the strict, legal, sense of the word, between the shareholders in the feeder fund and Nomad, or Sleep, Zakaria and Company, Ltd.

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The Nomad Investment Partnership is not a recognized scheme under the Financial Services and Markets Act 2000 ("FSMA"). Given the nature of Nomad's investor base, recourse to the FSA and the Financial Services Compensation Scheme may be limited.

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Nomad Investment Partnership

Interim Letter

For the period ended June 30th, 2010.

Cumulative results to June 30th, 2010.	Nomad Investment Partnership	MSCI World Index (net) US$
Trailing:		
One year	+38.1%	+10.2%
Two years	+15.4	-22.3
Three years	-5.6	-30.6
Four years	+22.3	-13.9
Five years	+34.7	+0.3
Six years	+70.0	+10.4
Seven years	+139.8	+36.9
Eight years	+195.0	+33.6
Since inception (Sept 10th 2001)	+238.2	+26.2
Annualized since inception		
Before performance fees	+14.8%	
After performance fees	+12.5	+2.7%

The figures above are unaudited, presented on a cumulative basis and, as ever, are before fees. Nomad's refundable performance fee and time dependent performance fee hurdle mean that the net-of-all-fees results will vary with subscription date and from investor to investor. Investors will, therefore, have their own unique net-of-all fees experience of investing in Nomad. As a guide we have also detailed overleaf the net-of-all-fees result from one point in time, in this case since inception. An index is used in the table to place our results in context with a broad swathe of share prices from around the world. We do not feel strongly about the merits of the index we have chosen, and Partners may wish to use another. Whatever the yardstick, we ask only that Nomad be compared over the very long-term. Below, the same pre-fee results are presented in discrete annual increments. In our opinion, it is the upper table that is most useful in assessing long-term investment performance.

Calendar Year Results to June 30th:	Nomad Investment Partnership	MSCI World Index (net) US$
2010 year to date	-2.7%	-9.8%
2009	+71.5	+30.0
2008	-45.3	-40.7
2007	+21.2	+9.0
2006	+13.6	+20.1
2005	+9.2	+9.5
2004	+22.1	+14.7
2003	+79.6	+33.1
2002	+1.3	-19.9
2001 (inception Sept 10th 2001)	+10.1	+3.6

The New Year brought Nomad's tenth calendar year of operations. Since we began, a dollar invested in Nomad at inception has grown to be worth $2.82 net-of-all-fees, as of June 30th, whilst a dollar invested over the same period in the average share, as reflected in the index above, would be worth around $1.26. Put another way, net asset value has compounded at 12.5% per annum, whilst the index has managed 2.7%.

Some Observations on the Nature of Comparative Advantages

There are, perhaps, few things finer than the pleasure of finding out something new. Discovery is one of the joys of life and, in our opinion, is one of the real thrills of the investment process. The cumulative learning that results leads to what Berkshire Hathaway Vice-Chairman Charlie Munger calls *"worldly wisdom"*. Worldly wisdom is a good phrase for the intellectual capital with which investment decisions are made and, at the end of the day, it is the source of any superior investment results we may enjoy. So, when analysing a firm, one just knows one is on to a good thing when one learns something new and the penny finally drops. And many times more fortunate if that insight can be applied more generally across businesses.

Take, for example, a recent research trip to a Welsh insurance company. The firm's products are nothing special, primary auto insurance sold to customers who buy mainly due to the legal requirement to be insured on the public roads. There is little product differentiation across the industry and the customer purchase decision is

usually driven by price. This is a soul-less relationship: it is near on impossible to get customers to love their insurance companies and, for their part, insurance companies don't give the impression they love their customers much either. Be that as it may, the firm we visited has a wonderful track record of financial results going back decades. Not just good by insurance industry standards (a low hurdle to jump if ever there was one), but good by any standards. So, what is going on?

It is tempting when analysing such situations to look for the big thing the firm does right. In effect, one is looking for the smoking gun that explains the firm's success. A smoking gun may be a vivid image, but the world does not always work like that. I should have known better when I asked what big idea had led to the firm's success: "*No, no, Nick, there is no secret sauce here*", one senior executive explained, "*we don't do one thing brilliantly, we do many, many things slightly better than others*". I have heard this line frequently over the last twenty or so years, and I have always dismissed it as a fig leaf covering the lack of any real corporate advantage. And I think that all this time I may have been wrong.

Take Costco Wholesale: Costco's advantage is its very low cost base, but where does that come from? Not from low cost land, or cheap wages or any one big thing but from a thousand daily decisions to save money where it need not be spent. This saving is then returned to customers in the form of lower prices, the customer reciprocates and purchases more goods and so begins a virtuous feedback loop. The firm's advantage starts with 147,000 employees at 566 warehouses making multiple daily decisions regarding U$68bn worth of annual costs. It's thousands of people caring about thousands of things a little more, perhaps, than may occur at other retailers. No fig leaf here. When Zak and I met Jim Sinegal, Costco's CEO, Jim suddenly stopped in mid-sentence, his face lit up, "*I must show you this*" he said and disappeared into a filling cabinet. He emerged with a memo from 1967 written by Sol Price, Fed-Mart's founder (the predecessor firm to Costco), "*here you can have a copy of this*" he said, and that copy is framed on our office wall. The memo says this,

> *"Although we are all interested in margin, it must never be done at the expense of our philosophy. Margin must be obtained by better buying, emphasis on selling the kind of goods we want to sell, operating efficiencies, lower markdowns, greater turnover, etc. Increasing the retail prices and justifying it on the basis that we are still "competitive" could lead to a rude awakening as it has with so many. Let us concentrate on how cheap we can bring things to the people, rather than how much the traffic will bear, and when the race is over Fed-Mart will be there".* [The best summary of the business case for scale economics shared we have come across].

Forty-three years later, almost to the day, and Costco is the most valuable retailer of its type in the world. Cultures that care about the little things all the time are very hard to create and, in the opinion of Amazon.com founder Jeff Bezos, almost impossible to create if not put in place at the firm's genesis. (It may be worth noting that, in contrast, most businesses cut costs sporadically, often-in response to a crisis, as part of plan B as it were. With their backs to the wall, good costs (investment spending) may be cut as well as bad costs (bloat), with the result that the savings prove counter-productive in the long run). The Welsh insurance company was founded by a man who cared passionately about the little savings, and he institutionalised this

orientation into the culture of the firm from the beginning. It was the way they lived, it was part of their raison d'être: it was plan A. And they shared that saving with their customers. Although I was slow to grasp the point, the insurance firm's advantage was very similar to that which had built Costco and builds Amazon today.

My mistake in not recognising that these businesses share similar roots (*"D'oh!"* as Homer Simpson might say) might be termed by psychologists as a *"framing"* error. When looking for an explanation to a situation the brain tends to latch on to what can be easily found to "frame" the situation, and if what is easily found is also vivid, then the brain stops looking for another explanation. I had gone looking for what I thought ought to be there, a vivid smoking gun such as a brand name, a location, a clever re-insurance contract, or a patent. However there is no a priori reason why a comparative advantage should be one big thing, any more than many smaller things. Indeed an interlocking, self-reinforcing network of small actions may be more successful than one big thing. Let me explain.

Take a one-big-thing-firm, such as a drug company, for example. A successful drug firm does not need to be particularly good at marketing, manufacturing, or research and development for that matter if, through a patent, it has a legal monopoly on a drug. But just look, if you will, at how fragile the drug company ecosystem is. A rival could displace it at any time with a better chemical and the firm would be left with little to fall back on, certainly not marketing, R&D, and manufacturing. Its period of exceptional profitability may therefore be quite finite and the big drug firms wrestle with this issue today.

Contrast this with a scale economics business: To better an incumbent's cost base a rival would have to be superior at, not one thing, but a million little actions – a far harder task. Amazon's letter to shareholders this year contains the following section:

> *"…We believe that focussing our energy on the controllable inputs to our business is the most effective way to maximise our financial outputs over time…we've been using this same annual [goal setting] process for many years. For 2010, we have 452 detailed goals, with owners, deliverables and targeted completion dates".*

At Amazon one employee initiative to remove the light bulbs from the vending machines (really!) saves the firm U$20,000 per annum! At the Welsh insurance company the penny dropped: firms that have a process to do many things a little better than their rivals may be less risky than firms that do one thing right because their future success is more predictable. They are simply harder to beat. And if they are harder to beat then they may be very valuable businesses indeed.

The Subtle Implication for Long-Term Investors

The opportunity for Nomad's investors comes from realising to whom these firms are more valuable. Certainly not the short-term investor, who will be indifferent as to whether Amazon, Asos or Air Asia will be the most valuable retailer/fashion etailer/airline in the world in ten years time. The institutional fund manager may be similarly indifferent. This collective professional myopia presents the true long-term

investor with the spoils, but the mechanism for this wealth transfer from short-term holder to long-term investor is subtle.

When investors value a business they have in their minds, consciously or not, a decision tree with the various branches leading to all possible futures and probabilities attached to those branches. The share price can be thought of as an aggregate of the probability weighted value of these branches. The problem, as Santa-Fe Institute scientist Ole Peters most recently pointed out (SFI Bulletin 2009, volume 24), is that this is not an accurate representation of what the future will be! The next step for the company will not be to visit all of those branches simultaneously. In reality the firm in question will only visit one of those branches before proceeding to the next and so on. Short-term investors spend their time trying to handicap the odds of each branch.

Guessing which-branch-next can be a crowded trade, but it's fine, as far as it goes. However, it rather misses the big picture, in our opinion. We would propose that some businesses, once they have progressed down the first favourable branch, stand a much greater chance of progressing down the second favourable branch, and then the third, as a virtuous feedback loop builds. The process takes time, but a favourable result at any one stage increases the chances of success further down the line, as it were. Think of it as a business' culture.

Take Air Asia: The firm was born with a no frills, cost culture with the result that, we estimate, it is the lowest cost airline in the world: this is favourable branch one. Favourable branch two: the employees take pride in the firm, suggest their own savings and the savings are implemented. Branch three: the savings exceed the peer group and are given back to customers in the form of lower prices. Branch four: the customer reciprocates and revenues rise. Branch five: further scale advantages lead to more savings per seat flown. Branch six: further customer reciprocation. Branch seven: the network builds and crowds out other, less efficient airlines. Branch eight: competitors go out of business?

The point is that the odds associated with any of these branches are not static but, in a hugely important way, they improve as one travels from branch to branch. Imagine the payoff in a game with these attributes? If investors recognise the inevitability of these improving odds they are also usually indifferent to them, perhaps viewing the eventual greatness of a business as simply outside their time horizon. Nevertheless, the effect of this indifference on share prices is to leave long-term success undiscounted (note, share prices are an aggregate of all possible future worlds, not the actual future) and the rewards from that observation may be enormous for the patient few. We certainly expect so.

The Following Paragraph is Important.

The thoughtful, easy patience of our clients therefore has an important part to play in the process. It is the rational way to respond to our investment in firms that are playing a long game, as it completes the favourable ecosystem. Please do not under-estimate the importance of your role in the process. You do us a great honour by being a calm hand on the tiller. Thank you.

Readers that make it to the end of our letters (we may be flattering ourselves), including the footnotes (we may be deluding ourselves!), may recall the story we retold of the Ferrari 250 GTO bought by a collector in the 1960s for the effective price of £750. The beauty of the story is that although the car is one of the most valuable in the world, the collector still has his car today. A different 250 GTO has recently changed hands, and the price…US$20m! It makes Nomad's tripling look rather pedestrian. Better get back to those annual reports.

As always, *"take heart and look to the horizon…"*. Enjoy the summer.

Yours sincerely

Nicholas Sleep

Our Footnotes

There is, we are told, a ticket kiosk at a railway station somewhere in India with a sign above the window that reads, "*No Bamboozlement Here*". It is in the same spirit that we attempt these cautionary words. Disclaimers boil down to the following statement – if you choose to believe any of this, then you are on your own. Yikes! It will be hard for us to escape this conclusion too, and it makes little sense for us to do anything but disclaim liability for errors, omissions and offer no warranties – please, check everything we say, let us know when we are wrong and forgive our errors. We do promise you this: we are human, we make mistakes, but our mistakes are honest ones. Although we do not intend to mislead, we also cannot guarantee the information in these letters, or that some of our ideas may be interpreted in ways we do not intend. As investors we are trying to do as good a job as we can and we write these letters in good faith to inform and educate investors on our actions and thinking in the context of the Partnership. We hope that they will be read in the same spirit in which they are written.

Common sense tells you that the price and value of shares can vary greatly, and whilst we do not aim for this, we also recognize that permanent impairment of capital is possible. Our Partnership is concentrated in relatively few investments, perhaps more concentrated than many others, and as such our results will be more volatile than many of our peers. Nomad is also a very long-term Partnership. We do not think it is suitable for investors with time frames less than five years. We also do not think Nomad is suitable for investors overly conflicted with principal-agent issues. If you are at all uncomfortable then, we suspect, Nomad is not for you.

The Nomad Investment Partnership has had two General Partners, Marathon Asset Management for the period from inception in 2001 to September 2006, and Sleep, Zakaria and Company, Ltd. from September 2006 until the present day. Zak and I have been responsible for the investment decisions of the Partnership since inception, formerly as employees of Marathon and then at our own firm, which was set up for the purpose of managing Nomad. The adventure continues…

Some notes on Housekeeping (stay awake at the back!)

This is the interim letter and, combined with the annual letter sent to investors in January, is the main format we use to communicate to our investors. In these letters we have tried to honestly and thoroughly provide all the information we would seek if the tables were turned and we were investors in someone else's fund. We own shares for very long periods and we are conscious that more frequent or detailed reporting may be unnecessary and even counterproductive. A copy of our magnum opus, the full Collection of Letters, is available upon request from Amanda at Galactic HQ (amanda@sleepzakaria.co.uk). Lots of coffee required. Investors in Nomad will also receive a full copy of our Schedule of Investments by separate post, every six months, which lists all of our investments in detail. In addition, in the spring you will receive Nomad's annual accounts, audited by Ernst and Young, which was produced in record time this year and sent to investors in early March. Each month statements of account are sent to you by Nomad's administrator (not us!), Phoenix Financial Services in Dublin, Ireland. Please call Gavin Gray and his team (+353 18 450 8161) with your statement queries. As should taxable US investors as Gavin and his team prepare their tax certificates (1099s) as well. Clients should always consider Zak and me to be available at the end of the phone, and our (somewhat shabby) front door open to visitors. And whilst we welcome your company, please don't be too disappointed if we don't have much that is new to say: we hope it is in the letters already.

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Nomad Investment Partnership

Annual Letter

For the period ended December 31st 2009

To December 31st 2009	Nomad Investment Partnership	MSCI World Index (net) US$
Trailing:		
One year	+71.5%	+30.0%
Two years	-6.2	-22.9
Three years	+13.7	-16.0
Four years	+29.2	+0.9
Five years	+41.0	+10.5
Six years	+72.2	+26.7
Seven years	+209.3	+68.7
Eight years	+213.3	+35.1
Since inception (Sept 10th 2001)	+245.0	+40.0
Annualized since inception		
Before performance fees	+16.1%	
After performance fees	+13.7%	+4.1%

The figures above are unaudited, presented on a cumulative basis and, as ever, are before fees. We present results in this way as Nomad's refundable performance fee and time dependent performance fee hurdle mean that the net-of-all-fees results will vary with subscription date and from investor to investor. Whilst investors will, therefore, have their own unique net-of-all fees experience of investing in Nomad, as a guide we have also detailed overleaf the net-of-all-fees result from one point in time, in this case since inception. An index is used in the table to place our results in context with a broad swathe of share prices from around the world. We do not feel strongly about the merits of the index we have chosen, and Partners may wish to use another. Whatever the yardstick, we ask only that Nomad be compared over the very long term. Below, the same pre-fee results are presented in discrete annual increments. In our opinion, it is the upper table that is most useful in assessing long term investment performance.

To December 31st :	Nomad Investment Partnership	MSCI World Index (net) US$
Calendar Year Results:		
2009	+71.5%	+30.0%
2008	-45.3	-40.7
2007	+21.2	+9.0
2006	+13.6	+20.1
2005	+9.2	+9.5
2004	+22.1	+14.7
2003	+79.6	+33.1
2002	+1.3	-19.9
2001 (inception Sept 10th 2001)	+10.1	+3.6

The New Year brings Nomad's tenth calendar year of operations. Since we began, a dollar invested in Nomad at inception has grown to be worth $2.90 net-of-all-fees as of January 1st, whilst a dollar invested over the same period in the average share, as reflected in the index above, would be worth around $1.40. Put another way, net asset value has compounded at 13.7% per annum, whilst the index has managed 4.1%.

Trust and Thank You!

A sixteen percent per annum investment return (i.e. pre-fees) has been achieved without leverage, derivatives, options, selling short, contracts for difference, LYONs, PRIDES (a pride of lions, perhaps?), TYGRs, STRYPES (we are not making these names up) or any of the other exotica the investment industry uses but, instead, it has been achieved the old fashioned way, through stock-picking. However, Zak and I do not operate alone in our stock-picking efforts. There were two important events in the last few years where you, our Partners, meaningfully added to returns. The first was to vote in early 2008 for Nomad's delisting from the Irish Stock Exchange. This motion allowed us to make much larger single-company investments than had been the case up to that point. Today, net asset value is approximately twenty percent greater than had the size of our investments remained artificially capped by the stroke of a bureaucrat's pen. Bravo!

Second, last year you did not redeem. The return to date from that action alone will be in the order of seventy percent (and counting!). Trusting people is not easy, but even so, you have trusted us far more than I am aware occurs at any other fund management organisation, and we thank you. Do not dismiss the effect your calming influence has on the Nomad ecosystem. These results are yours, as much as ours. Indeed, given the parlous balance of the refundable performance fee account for our long term investors, they are all yours! Well, all yours in exchange for around twenty basis points in management fee. Bargain.

Even though it may be tempting to flatter oneself, it is the businesses we invest in that do almost all the heavy lifting in the wealth creating process. If Zak and I bring something to the investment party, and I may be stretching things a little here, it is to be more rational than other investors. At least, we hope that is the case. Your trust, in turn, allows us to invest in firms that are misunderstood by many. For example, we invest in firms that pay their employees 80% more than rival companies (Costco); firms that lower prices as an article of faith (Amazon.com); firms that force an equitable distribution of commissions in an industry dominated by an eat-what-you-kill culture (Michael Page); a low cost airline for the masses in a region served by airlines for the rich (AirAsia); and a company that thinks table top figurine games are cool, really, (Games Workshop). Isn't it wonderful that these firms are behaving in this way despite being misunderstood by the outside world? All the social pressure will be to conform with industry norm but these companies have a deep keel that keeps them upright.

Your trust allows us to make mistakes (Conseco, Fleetwood Enterprises – please don't point out they are from the same industry!) and change our mind quickly and without fear of rebuke (MBIA); invest in brilliant businesses (Amazon, Berkshire Hathaway, Costco et al) and so-so businesses (Stagecoach Group, Holcim Philippines, USG); invest with great concentration (Stagecoach, Amazon, Michael Page) and in baskets of several small holdings (four companies in Zimbabwe). We do these things because it is rational to invest that way and, if our results are a guide, it works! Nomad would be ranked in the top cohort of almost any peer group league table for our cumulative performance since inception.

Careful what you wish for

In previous letters we have described the split that exists between Nomad's approach and that of the industry in terms of the principal-agent conflict, or manifestations thereof, such as short investment holding periods. I don't want to make too much of these as, in part, I do not think we are saying much that is new and I think it should also fall on the so-called "*professional fund management industry*" to defend its practices. Indeed, it seems to us that it is the industry that has to constantly say something new to keep the game going: new funds, new products, new investment stories, new "*aligned*" performance fees, new firms. Each new new thing is in turn supported with lots of marketing, perhaps in an attempt to give the new things extra oomph over the, now demoted, old things. At any rate, one cumulative effect of years of the industry's shouted marketing claims has been to elevate well-meaning concepts to the status of industry dogma. In part, this happens through the crowding out of contrary argument. For example, "*specialisation*" and "*diversification*" are at the heart of many marketing claims and sound wholesome and prudent enough, a little like

motherhood and apple pie. However, such notions, if run to extremes, can be counter-productive. For example, a widely held view in the noughties mortgage market was that the risk of "*specialised"* lending to the less credit-worthy could be removed through "*diversification*". It was all sales talk, but it worked, in part, as the salesmen were able to promote their products as "*safe*" because specialisation and diversification were traits so highly prized by the rube investor. False traits, it turned out, as the products were not diversified and their complexity made them all but un-analysable. Specialised indeed! A U$1 trillion case of 'careful what you wish for'. Such a ruse does not just exist in the credit markets: many equity portfolios are constructed using similar principles.

The Locker Room Culture

The attitude of the builders and sellers of these new things may be akin to what Charlie Munger called the "*locker room culture*". This is an attitude whereby the players just have to win, and they are not too squeamish about the means. And if winning, for some, meant securing a bigger bonus than others, then, in the case of the mortgage market, any way to get people to buy expensive paper was just fine, and to hell with the consequences. This is a proud, manipulative, points-scoring orientation that manifests itself in all walks of life, but may be especially evident on Wall Street, although some salesmen, sportsmen, chief executives, politicians, warlords and hedge fund types are notably not exempt. It is perhaps the dominant, get-ahead mindset of our times and it is inherently focused on vivid, short term outputs. Sales targets and profit margins achieved through cutting corners may be inherently worthless in the end, but they can dazzle for a while, and that is their value to the locker room set.

If we are honest, we have all been tricked by the unscrupulous salesman and his short term promises. It is, perhaps, part of growing up. Zak and I have certainly responded, with order sheet and pen at the ready, to firms that have explicitly promised revenue and margins targets, without really considering how those targets were to be earned or whether they were sustainable. Oh dear! One-nil to the locker room set. In the end though, the sin and folly of the locker room culture, with its win at any costs attitude, does huge damage to us all.

A great deal has been penned on why the locker room mindset exists in listed businesses. However, it is interesting that the commentary has, to date, been almost deferential towards shareholders, who are cast more as victims of scandals rather than sowers of their own misfortune. We would argue a contrary view: if the shareholder base of a listed firm is dominated by, say, mutual funds that, in turn, are seeking short term performance, then that too will be what they will seek in their investments. An odd pact may, therefore, develop between the immediate business imperatives of the salesforce-controlled mutual fund and, say, the consumer goods company with earnings to hit. Both parties will care for short term outputs and will take from the long term to meet their needs. All parties will invariably be in denial that this is the case, at least to their clients but, we ask, how are the incentives aligned? We would argue that not only do companies get the investors they deserve, but investors also get the companies they deserve.

Schlock begets schlock, as it were.

Operating inside the bubble, it is hard for many participants to see this. The author Upton Sinclair, commenting on the attitude of businessmen and almost one hundred years to the day before the current credit crisis, had it about right, "*it is difficult to get a man to understand something when his salary (or bonus) depends on his not understanding it*". So, the mindset is prevalent because it pays in the short term. But this does not make it the right thing to do, nor does it make it profitable over the long term.

Doing what is right rather than what plays well.

Zak and I far prefer a different approach. We would argue that locker room behaviour is more likely to be spotted by patient, generalist investors deploying common sense, as it helps to be outside the bubble to see the bubble. It may also aid one's thinking if the investor is prepared to make a meaningful, long term investment as this breaks the in-out, get-rich-quick spell of the salesman (and, let's face it, the salesman in one's own head!). Our anti-locker room disposition was echoed by the founder of one of Nomad's investee firms, who, in a private meeting, put it as follows: "*if you want to be successful, and we do, then you have to be willing to be misunderstood, and do things that do not seem sensible to most people*". For example, "*if you* (employees) *come in to the office in the morning thinking how you are going to beat number one, two or three in the industry"* - how many times have we heard companies articulate that view? - *"then, our firm is the wrong place for you. We start with the customer and work backwards*." Oh, sweet nectar! He continued that rather than set your standards by what others do, the firm benefited from a "*divine discontent*" with the status quo, which kept colleagues on their toes and the firm improving, irrespective of what the competition were doing. In other words, his company had an internal compass with true north pointing to what was right for the customer.

This orientation strikes us as the antithesis of the locker room set.

Character as a way of reducing reinvestment risk

Judging by our hit rate with companies interviewed, Zak and I would guestimate that fewer than five percent of publically listed firms do what they think is right, rather than what they think plays well with the outside world (media, Wall Street, investors). Even so, the vast majority of Nomad's firms do what is right long term. But I suspect we have a predilection for such people. Which brings us on to an important characteristic of Nomad today that we hope will affect results for years to come.

There are, broadly, two ways to behave as an investor. First, buy something cheap in anticipation of a rise in price, sell at a profit, and repeat. Almost everybody does this to some extent. And for some fund managers it requires, depending upon the number of shares in a portfolio and the time they are held, perhaps many hundred decisions a year. Alternatively, the second way to invest is to buy shares in a great business at a reasonable price and let the business grow. This appears to require just one decision (to buy the shares) but, in reality, it requires daily decisions not to sell the shares as well! Almost no one does this, in part because it requires patience - and the locker room set does not do patience - but also because inactivity is the enemy of high fees.

Regardless of how it may appear, Zak and I are drifting toward inactivity, at least as

judged by our industry. As we have set out in earlier letters, in part this is because we realise through vicarious, and not so vicarious (!), experience that we do not know that much. We certainly do not have an opinion on many hundred shares, at least, not an opinion in which we would invest money. Second, we have learned or, rather, come to appreciate, that the character of a firm - call it the ability to resist locker room temptation - is far more important than first we realised. This is an important insight. In the long run it may be all that matters. And note,

Nomad is overwhelmingly invested in businesses of great character.

Third, if our firms can successfully grow, and we can resist the temptation to fiddle, then we can meaningfully reduce the reinvestment risk embedded in lots of share buying and selling. Finally, great businesses have been "on sale" and were, in our opinion, the investment opportunity of the credit crisis period. When we wrote to you a year ago we said, "*It may not feel like it but for a long term investor this is the best of times not the worst…Take heart and look to the horizon.*" Today we have a portfolio of exceptional, iconoclastic businesses that we could own for many years.

This is investment heaven.

We wish you a very successful new decade.

Yours sincerely,

Nicholas Sleep

Our Footnotes - "No Bamboozlement Here"

There is, we are told, a ticket kiosk at a railway station somewhere in India with a sign above the window that reads, "*No Bamboozlement Here*". It is in the same spirit that we attempt these cautionary words. Disclaimers boil down to the following statement – if you choose to believe any of this, then you are on your own. It will be hard for us to escape this conclusion too, and it makes little sense for us to do anything but disclaim liability for errors, omissions and offer no warranties – please, check everything we say, let us know when we are wrong and forgive our errors. We do promise you this: we are human, we make mistakes, but our mistakes, we hope, are honest mistakes. Although we do not intend to mislead, we also cannot guarantee the information in these letters, or that some of our ideas may be interpreted in ways we do not intend. As investors we are trying to do as good as job as we can and we write these letters in good faith to inform and educate investors on our actions and thinking in the context of the Partnership. We hope that they will be read in the same spirit in which they are written.

As authors we assert our copyright. However, we also understand that our letters are passed on. We ask only that you attribute our work to us.

Common sense tells you that the price and value of shares can vary greatly, and whilst we do not aim for this, we also recognize that permanent impairment of capital is possible. Our fund is concentrated, perhaps more than many other funds, and as such our results will be more volatile than many of our peers. Nomad is also a very long term fund. We do not think it is suitable for those with time frames less than five years. We also do not think Nomad is suitable for investors overly conflicted with principal-agent issues. If you are at all uncomfortable, then Nomad is not for you.

The Nomad Investment Partnership has had two General Partners, Marathon Asset Management for the period from inception in 2001 to September 2006, and Sleep, Zakaria and Company, Ltd. from September 2006 until the present day. Zak and I have been responsible for the investment management of the Partnership since inception, formerly as employees of Marathon and then at our own firm, which was set up for the purpose of managing Nomad. The adventure continues…

Legal Footnotes

Performance numbers are produced by Phoenix Fund Services, Nomad's administrator, and are audited by Ernst and Young in their annual audit, which follows publication of our letters.

In our letters we refer to both limited partners in the Partnership, and common shareholders in the Nomad Investment Company (feeder fund) as "Partners". We do this to convey a relationship we seek in which our investors are partners in a shared experience and destiny, in which they too have something to contribute. We do not mean to suggest that there is a partnership, in the strict, legal, sense of the word, between the shareholders in the feeder fund and Nomad, or Sleep, Zakaria and Company, Ltd.

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Nomad Investment Partnership

Interim Letter
For the period ended June 30th, 2009

To June 30th, 2009	Nomad Investment Partnership *	MSCI World Index (net) US$
Trailing:		
Year to date	+20.9%	+6.4
One year	-16.5	-29.5
Two years	-31.7	-37.0
Three years	-11.5	-22.2
Four years	-2.5	-9.0
Five years	+23.1	+0.2
Six years	+73.6	+24.2
Seven years	+113.5	+21.2
Since inception (Sept 10th 2001)	+144.8	+14.6
Annualized since inception:		
Before performance fees	+12.1%	+1.8%
After performance fees including performance fees reimbursed	+9.6	

The figures above are unaudited, presented on a cumulative basis and, as ever, are before performance fees. Below the same results are presented in discrete annual increments. In our opinion it is the upper table that is most useful in assessing long-term investment performance.

To June 30th, 2009:	Nomad Investment Partnership	MSCI World Index (net) US$
Calendar Year Results:		
2009 (year to date)	+20.9%	+6.4%
2008	-45.3	-40.7
2007	+21.2	+ 9.0
2006	+13.6	+20.1
2005	+9.2	+9.5
2004	+22.1	+14.7
2003	+79.6	+33.1
2002	+1.3	-19.9
2001	+10.1	+3.6

"This Abstract, which I now publish, must necessarily be imperfect. I cannot here give references and authorities for my several statements; and I must trust to the reader reposing some confidence in my accuracy. No doubt errors will have crept in, though I hope I have always been cautious in trusting to good authorities alone. I can here give only the general conclusions at which I have arrived, with a few facts in illustration, but which, I hope, in most cases will suffice. No one can feel more sensible than I do of the necessity of hereafter publishing in detail all the facts, with references, on which my conclusions have been grounded; and I hope in a future work to do this. For I am well aware that scarcely a single point is discussed in this volume on which facts cannot be adduced, often apparently leading to conclusions directly opposite to those at which I have arrived. A fair result can be obtained only by fully stating and balancing the facts and arguments on both sides of each question; and this cannot possibly be here done."

So begins paragraph three of "On the Origin of Species by Means of Natural Selection" by Charles Darwin, the bicentenary of whose birth falls this year. The book took Darwin twenty years to write and may have done more than any, with the exception of the Bible, to shape man's self-perception. But just look, if you will, at the language of the introduction:

"This Abstract must necessarily be imperfect…no doubt errors have crept in… I can here only give the general conclusions…I am well aware that scarcely a single point is discussed on which facts cannot be adduced, often apparently leading to conclusions directly opposite to those at which I have arrived…A fair result can only be obtained by fully stating and balancing the facts on both sides".

One can hardly accuse the man of promotion! Darwin knew he was right but his findings troubled him personally. He was a Christian, in a Christian society, indeed he had considered studying theology before setting sail on HMS Beagle, and his new ideas challenged the church, his countrymen and his conscience. At major turning points in society, such as he was suggesting, how many of us, we wonder, would be modest about what we had discovered? Darwin's humility is an attractive human quality, perhaps because such understatement recognizes that the ideas were bigger than the man. Which, of course, they were. It is an interesting subconscious psychological tendency that truths are often spoken with a whispered voice whilst

shaky suppositions are shouted for all to hear. It is not so much us that the shouters are convincing, as the need to convince themselves. We all shout to some extent, with agents usually shouting louder than principals: and that should tell us something. In the Nomad ecosystem we do try to keep the volume down somewhat. Like Darwin, perhaps, but on a very different scale, we recognize a few simple truths and we are conscious that our views, in the eyes of our peers, may not be very popular.

Empty Vessels and a Quieter Approach.

Upon reflection, it is curious that this quiet attitude extends, in its own way, to the companies in which we have entrusted your dollars: Amazon and Costco do not advertise (no shouting here); Berkshire Hathaway and Games Workshop do not provide earnings guidance (popular with baying fund managers and stock brokers); Amazon, Costco, AirAsia, Carpetright, and parts of Berkshire give back margin to the customer, we would argue that is a pretty humble strategy too. In other words, around two thirds of the portfolio is invested in firms that in some major way shun commonplace promotional activity and they are no less successful as a result. If one steps outside of stock market listed companies to instead observe private firms run by proprietors and founders, it is the quiet approach that is far closer to the norm. Let's invert: why are publicly listed companies so promotional about their affairs? Are these companies shouting to inform shareholders and customers or convince themselves?

Nomad's investments may be in publicly listed firms but these firms are also overwhelmingly run by proprietors who think and behave as if they ran private firms. Amazon for example struggles with institutional investor relations so much so that the good people that man the IR department do so knowing that the firm's founder, Jeff Bezos, thinks their role is all but a waste of time! Poor souls. Bezos was also quite forthright on the subject of product promotion and advertising at this year's annual general meeting:

"*Advertising is the price you pay for having an unremarkable product or service*".

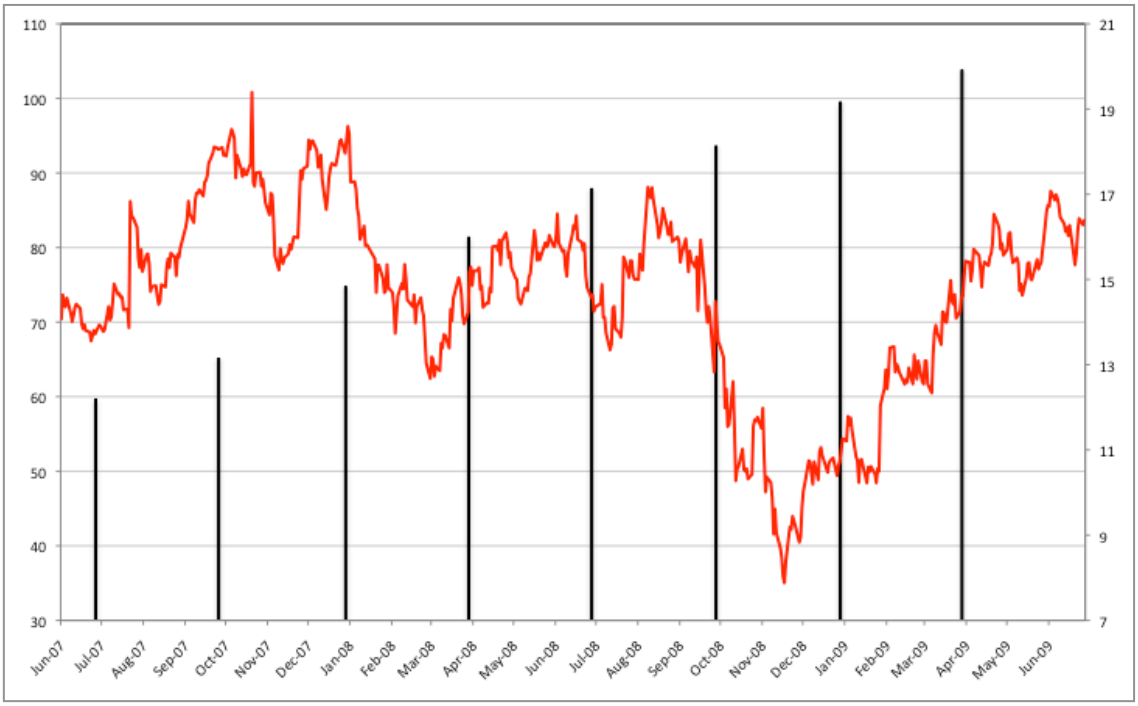
It is interesting to note that the other end of the promotional scale is exemplified by the pop star razzle of General Motors which had the largest advertising budget of any company whose annual report we read this year (actually that title went to GM last year, and the year before, and the year before…). The advertising spend was U$5.3bn in 2008, or U$630 per car delivered. It is fun to muse that had the company made cars that required little advertising support, then the firm's last five-years' advertising spend may have been sufficient to retire half of the company's debt, at par, instead! But, it seems, it was easier to call Madison Avenue than build cars that sold themselves. GM is very much the empty vessel making the most noise, in this regard.
Our portfolio takes a different path. The whispered voice of price givebacks is economically fruitful but only if the customer reciprocates in the form of more spending, even in the face of more promotional approaches by competitors. For evidence that this is the case with our whisperers look no further than the average revenue growth rate of the largest investments in Nomad (including some of the companies mentioned above, err, not GM!) which, in the most recent reporting period, was in excess of ten percent!

Why? In a word, price. It is in times like these that the hyper-efficient low cost providers, who share the benefits with their customers, often take permanent market share. This fact rather reminded us of a quip by Wal-Mart founder, Sam Walton, who, when asked about the recession of the early 1990s, stated:

"*I've thought about it, and decided not to participate*".

Amazon, for example, is choosing "*not to participate*" in as much as trailing twelve-month revenues have risen by over sixty percent since the onset of the credit crisis, say mid 2007. Not that the steady growth in revenues has always been apparent in its stock price, as the chart below describes. As a youthful analyst I used to have a notice on my desk that read, "*share prices are more volatile than corporate cash flow, which is more volatile than asset replacement cost*". It was reminder to concentrate on non-transitory items. Today I would update such a notice to read, "*share prices are more volatile than business values*", but the gist is the same: a reminder to focus on lasting value, not transitory prices. More on this subject later in this letter.

Chart 1: Make up your mind, U$100 or U$40? Trailing twelve-month revenues (in billions of dollars, rhs) and share price (lhs).



Source: Company accounts, Bloomberg, Sleep, Zakaria and Company, Ltd.

The Investment Industry and Over-Diversification, again.

In business, thoughtful whispering works, which makes it all the more remarkable that the investment industry, as well as many economic commentators, spend so much time shouting. So much commentary espouses certainty on a multitude of issues, and so little of what is said is, at least in our opinion, knowable. The absolute certainty in the voice of the proponent so often seeks to mask the weakness of the argument. If Zak and I spot this, we metaphorically tune out. In our opinion, just a few big things

in life are knowable. And it is because just a few things are knowable that Nomad has just a few investments.

The church of diversification, in whose pews the professional fund management industry sits, proposes many holdings. They do this not because managers have so many insights, but so few! Diversity, in this context, is seen as insurance against any one idea being wrong. Like Darwin, we find ourselves disagreeing with the theocracy. We would propose that if knowledge is a source of value added, and few things can be known for sure, then it logically follows that owning more stocks does not lower risk but raises it! Real diversification is offered by index funds at a fraction of the price of active management.

Sam Walton did not make his money through diversifying his holdings. Nor did Gates, Carnegie, McMurtry, Rockefeller, Slim, Li Ka-shing or Buffett. Great businesses are not built that way. Indeed the portfolios of these men were, more or less, one hundred percent in one company and they did not consider it risky! Suggest that to your average mutual fund manager. And it is interesting to note that none of the great fund management organizations got rich on the back of the most successful companies of the modern era either!

This failure goes largely unrecognized, and certainly ignored, perhaps because it is the elephant in the room. (Quick, change the subject). It is ignored because some fund managers are not trying to make clients rich per se, but instead their goal is to beat their peers or a benchmark. Fine, but what strikes us about such a disposition is that, somewhere in that frame of mind, one ceases to be an investor and starts to be a business manager and, to borrow a phrase from a popular UK TV advert, "*that's not what is says on the tin*". When investment skills share a seat with business management, in time, it's the commercial genes that tend to thrive, and investment skills that are not used end up atrophying. Is that why the fund management industry finds itself, like GM, relying so heavily on marketing?

Back to real investing! The trick, it seems to us, if one is to be a successful long-term investor, is to recognize the sources of enduring business success, get in early and own enough to make a difference. Which raises two questions: what are the sources of success and second, if these are so readily recognized up front why are they not discounted in prices already? We will spend the balance of this letter answering these two questions.

<u>Seeing, but not Understanding.</u>

How might corporate success be predictable? There are some clues in the world around us. Zak and I observe several business models that work in the long run, and scale economics shared is one of these, witness Ryanair, Wal-Mart, Geico, Southeast Airlines, Tesco, Nebraska Furniture Mart, Direct Line et al. And that is why companies that share scale with the customer such as Carpetright, Costco, Berkshire Hathaway, Amazon and AirAsia make up around sixty percent of the Partnership. It works because it turns size, normally an anchor to growth and returns, into an asset.
But I also don't think this is a great secret.

Investors are broadly rational people (they all knew that Wal-Mart was a wonderful business) and fund managers operate under healthy profit incentives that ought to foster good outcomes, so why is it that no one but the founding Walton family owned Wal-Mart all the way through? Zak and I were told a story by one of the industry's most senior fund managers which we enjoyed enormously, and might help illustrate the point. In the early 1970s a then, and still today, large successful fund management company analysed its portfolio and discovered that their sale of IBM thirty years earlier had been a huge error of omission. If they had instead kept their IBM shares for the last thirty years, that stake alone would have been larger than total funds under management. No doubt they all agreed to learn from that particular mistake and, as so often happens, went back to their desks and got on with life as before, as if nothing had happened. It is fun to note that, at about the same time, they also made the decision to sell their stake in Wal-Mart, which, thirty years later, would be worth more than their then-to-be funds under management! In terms of dollars of opportunity lost, it is likely to be the biggest single error this firm will make.
We offer the following reasons for this mistake:

1. Misanalysis, or using the wrong mental model: Investors are used to firms which have one good idea, such as a new product, but then struggle to replicate success and end up diluting returns (Zak and I call this the Barbie problem, as Mattel has struggled to replicate the economics of its famous doll). Taking this model and applying it to Wal-Mart would miss the company's source of success entirely as the strategy of price givebacks did not change from year to year; culture plays a part in the continuity of a successful price giveback strategy and factors such as culture, because they are hard to quantify, often go undervalued by investors; investors presume regression to the mean starts at the time of their analysis or, as CFA students may recognize, in year three or five of a DCF analysis! Investors use valuation heuristics rather than assess the real value of the business.

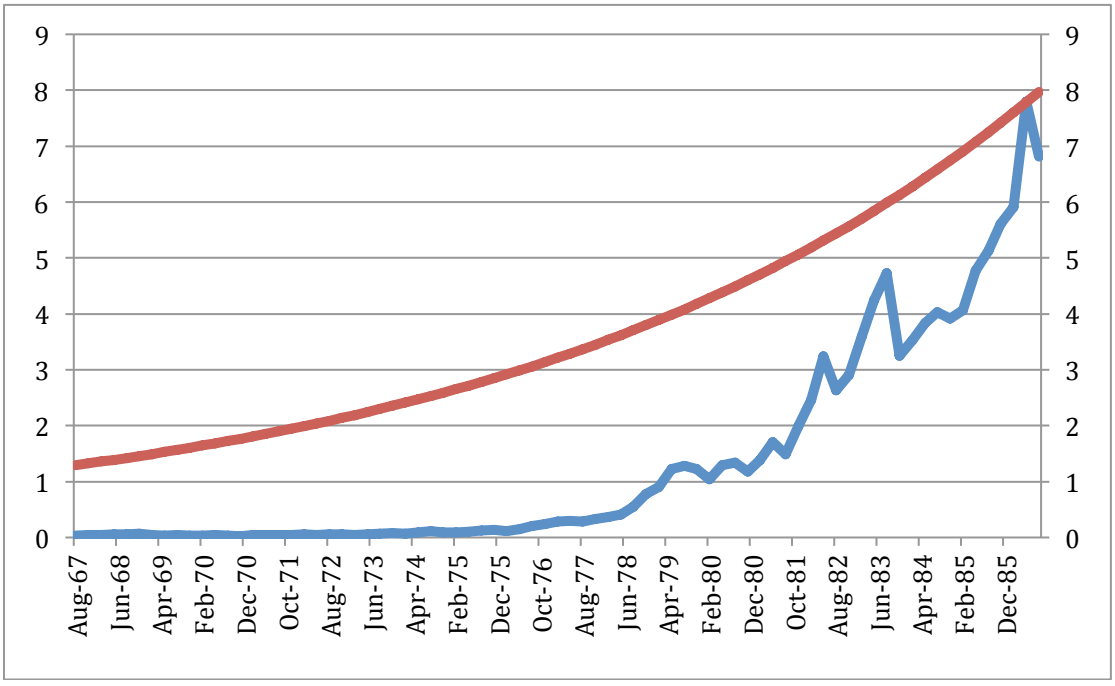
2. Structural or behavioral: Active fund managers have to look active. One way to do this is to sell Wal-Mart, which appeared expensive (but actually wasn't), to buy something that appeared cheaper (but err, also wasn't); investors are not long-term and did not look further than the next few years or, more recently, few quarters. Evidence for this can be gleaned from the average holding periods for shares which stands at just a few months; fund managers wish to keep their jobs and espousing a ten-year view on a firm risks being a hostage to fortune; marketing folks require new stories to tell and new stocks in the portfolio provide new stories; fund managers sell their winners in order to appear diversified in the eyes of their clients.

3. Odds or incorrectly weighing the bet: In the words of my first boss, investors tend not to believe in "*longevity of compound*". Conventional thinking has it that good things do not last, and indeed, on average that's right! Empirical Research Partners, an investment research boutique, discovered that the chance of a growth stock keeping its status as a growth stock for five years is one in five, and for ten years just one in ten. On average, companies fail.

The list above is far from exhaustive and we can all pick our favorites. No doubt some combination of these, plus others, acted in the minds of sellers. It matters not particularly. What matters is the effect of this collective mis-cognition. Investors know that in time average companies fail, and so stocks are discounted for that risk.

However, this discount is applied to all stocks even those that, in the end, do not fail. The shares of great companies can therefore be cheap, in some cases, for decades. To illustrate the point consider the graph below. The blue line represents the share price of Wal-Mart and the red line the price that one could have paid at any time since 1972 (the firm's initial public offering) and then earned a return of ten percent (a proxy for a reasonable equity return) through to today. The red line can be thought of as what the firm was really worth.

Chart 2: Cheap for Decades. Share price of Wal-Mart (blue) and the price one could have paid and still earned a ten percent return (red).



Source: Company accounts, Bloomberg, Sleep, Zakaria and Company, Ltd.

Just look how long the undervaluation persisted! If, in 1972, upon reading that year's twelve page annual report (!) an investor chose to make a purchase of shares, he could have paid over one hundred and fifty times the prevailing share price (a price to earnings ratio of over fifteen-hundred times, a ratio far in excess of what professional fund managers would consider prudent. They would be mistaken, as it turns out) and he would have still earned a ten percent return on his investment through to today. If, instead, the investor thought about it for a while and decided to purchase shares ten years later he could still have paid over two hundred times earnings for his shares (beware heuristics) and still earned ten percent on his investment. And ten years after that could also have paid a premium over the prevailing Wal-Mart share price and done well subsequently. The market struggled to appreciate the magnitude and longevity of the business' success. But why?

Weighting the Information.

Investors see the information (on conference calls they cheer "*great quarter, Wal-Mart*") but, in our opinion, they incorrectly weigh the information. It could be argued that lots of things had to go right for Wal-Mart to grow for forty years. That is certainly true but, at its heart, a very few simple things really mattered. In our opinion, the central engine of success at Wal-Mart was a thrift orientation fuelling growth with the savings shared with the customer. The culture of the firm celebrated this orientation and reinforced the good behaviour. This is the deep reality of the business. This should have had the greatest weighting in the minds of long-term investors even if other things looked more important at the time. Instead investors may place too much emphasis on valuation heuristics, or margin trends, or incremental growth rates in revenues or any of the list above, but these items are transitory and anecdotal in nature.

There are very few business models where growth begets growth. Scale economics turns size into an asset. Companies that follow this path are at a huge advantage compared to those, for example, that suffer from Barbie syndrome. Put simply: average companies do not do scale economics shared. Average companies do not have a healthy culture. After all, average companies are more like GM than Wal-Mart! The removal of a portion of failure risk from the investment equation creates a huge opportunity for those investors that can see the company in its true perspective and act with a bit of patience. It is a huge anomaly that investors recognize success incrementally when the factors that lead to success, such as scale economics shared reinforced by a strong culture, may be constant. If the early investors in Wal-Mart had understood this, they may have retained their holding along with the, now billionaire, Walton family.

The fund management industry has it that owning shares for a long time is futile as the future is unknowable and what is known is discounted. We respectfully disagree. Indeed, the evidence may suggest that investors rarely appropriately value truly great companies. We can hear the howls of derision from the professional cynics "that's twenty-twenty hindsight, guys!" Dare we whisper it, but in some cases we think that greatness may be knowable in, shhh, FORSIGHT! This "*longevity of compound*" opportunity exists precisely because the average fund manager is attending a different church. Thank God!

Simple, but not Easy.

When Zak and I trawled through the detritus of the stock market these last eighteen months (around a thousand annual reports read and three hundred companies interviewed) we had four main choices: add to existing holdings, invest in new firms, invest in growth businesses, invest in cigar butts. Overwhelmingly we have preferred our existing businesses to the alternatives. Of course, such a conclusion will only make sense if the businesses in which we have invested have great prospects and the shares are cheap. Like Darwin, perhaps, we are well aware that we live in an ambiguous world. And we are not saying, for example, that Amazon is the next Wal-Mart. Time will tell on this front. But we are asking the question, what if? The portfolio weightings are sizeable in the firms we consider to be the pick of the bunch,

and Nomad should do well if our firms grow from acorns to oaks. It is this rational will to believe and be patient that perhaps marks Nomad out from its peers.

What we are doing is investing at its most honest and most simple. But it is not easy. It is hard because one first has to reject industry dogma. The non-thought of received wisdom is shouted from the rooftops and it is safe and comfortable, glamorous, exciting even, being part of the crowd. The road less travelled is hard as there is lots of heavy lifting involved in the homework, although we happen to rather like the workout. As Darwin found, it is hard to let the facts speak for themselves, reject the established way of thinking and to do so in good conscience. And it is a blessing for us that the crowd have rejected something so obviously right as investing at its simplest. Phew, that was just as well! Indeed such is the lure of, what might be called, professional fund management techniques (!) that we find there is, albeit with a few notable exceptions, almost no competition for the long-term investor who has done his homework. Isn't it exciting that honest, simple, long-term investing is so, well, un-exciting.

The State of our Partnership.

Some facts and figures may help paint a useful aggregate picture of the Partnership. Zak and I think of the Partnership in terms of business models deployed by our investee firms. The names we use to describe these models are not that catchy but please bear with us. The largest group making up over half the Partnership are, no drum role required, scale-economics-shared; next comes discounts-to-replacement-cost-with-pricing-power (I warned you) at around fifteen percent; hated-agencies fifteen percent; super-high-quality-thinkers just under ten percent. The Partnership has twenty investments but a noticeable concentration in ten, which make up around eighty percent of the portfolio, and for those with sharp eyes around thirty percent of the Partnership in one investment. Although the bulk of the Partnership is listed in the United States, look-through revenues are far more diversified: US dollar revenues forty-seven percent, Euro and Swiss Franc revenues twenty-one percent, South East Asian currencies sixteen percent, Sterling ten percent, Yen three percent and others three percent. There are perhaps six main industry groups and their weightings are as follows: internet thirty percent, consumer staples sixteen percent, consumer discretionary fourteen, business services thirteen, insurance and finance eleven, and airlines eight percent, with a tail of smaller groupings.

Return on capital in the portfolio is extremely high, as are endemic growth rates. We estimate that around three-quarters of the portfolio is invested in growth businesses, which have the potential to compound for many years, and the balance in more cigar butt like investments (we just could not help it!). In aggregate the portfolio is priced in the market at meaningfully less than half our appraisal of what our firms are really worth. The Partnership will remain open to incremental subscriptions whilst this is the case. Here ends the marketing pitch from the chief marketing officer, who now announces his retirement!

One common psychological trap that agents may fall into is that clients expect action, or to be more accurate, fund managers expect their clients to expect action! The investor Seth Klarman was once challenged on whether Buffett's track record was statistically significant as he traded so little? To which Klarman answered that each

day Buffett chose not to do anything was a decision taken too. It is quite possible that we may not change the companies in which we have invested very much over the next few years. Indeed that is our preference. Zak and I expect that we have built a portfolio not just for the recovery out of recession but for many years after that too. At least, we aim for such a Zen-like state.

Housekeeping.

Our cost reimbursement management fees are running at around twenty basis points per annum. We could get it lower, but not by much, and would rather let it fall naturally as the fund grows in size. It is a fair estimate that, if Nomad was a billion dollars in size, the management fee would halve in basis point terms. We target single digit basis points in time. The reimbursable performance fee was, indeed, reimbursed to investors last year. And so it should be.

Thank You.

It is with the greatest delight, and respect, that we report that Nomad has had net subscriptions as a result of the credit crisis. I think that is a fact of which we can all be proud. And we have had nothing but notes of support during a period when the market, and gyrations in Nomad's share price, could have given much cause for concern. That ecosystem is special. Thank you.

As always, we thank you for your confidence and most especially your patience. Back to those annual reports.

Yours sincerely,

Nicholas Sleep

* Sleep, Zakaria and Company, Ltd., was appointed as investment advisor to the Nomad Investment Partnership with effect from September 12th 2006, replacing Marathon Asset Management who had been investment advisor to the Partnership since inception. Prior to this transition Nicholas Sleep and Qais Zakaria were responsible for the investment management of Nomad whilst employed by Marathon Asset Management. Partners should note that the very nature of the transition from Marathon to Sleep, Zakaria and Company, Ltd., means that the Partnership does not benefit from the same back office infrastructure support it used to receive. In this letter we use the term "partners" as a generic term referring to all Nomad investors, whether shareholders in the feeder fund (the Nomad Investment Company) or limited partners in the Partnership and not, in the strict, legal sense of the word, to imply the creation of a partnership between shareholders in the feeder fund, Nomad and/or Sleep, Zakaria and Company, Ltd.

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Nomad Investment Partnership

Annual Letter
For the period ended December 31st, 2008

To December 31st, 2008	Nomad Investment Partnership *	MSCI World Index (net) US$
Trailing:		
One year	-45.3%	-40.7%
Two years	-33.7	-35.4
Three years	-24.7	-22.4
Four years	-17.8	-15.0
Five years	+0.4	-2.5
Six years	+80.3	+29.8
Seven years	+82.7	+3.9
Since inception (Sept 10th 2001)	+101.1	+7.7
Annualized since inception		
Before performance fees	+10.1	
After performance fees	+7.1	+1.0

The figures above are unaudited, presented on a cumulative basis and are before fees, most notably, performance fees. As usual we quote performance before fee payments as Nomad's time dependent hurdle means that investors with different purchase dates will also have different net-of-all fees experiences. Below the same pre-fee results are presented in discrete annual increments. In our opinion it is the upper table that is most useful in assessing long-term investment performance.

To December 31st, 2008:	Nomad Investment Partnership	MSCI World Index (net) US$
Calendar Year Results:		
2008	-45.3%	-40.7%
2007	+21.2	+9.0
2006	+13.6	+20.1
2005	+9.2	+9.5
2004	+22.1	+14.7
2003	+79.6	+33.1
2002	+1.3	-19.9
2001 (inception Sept 10th 2001)	+10.1	+3.6

Thinking about Inputs: The Price to Value Ratio

It is quite something to arrive at the end of a five-year period and for Nomad's returns to be all but zero, and precious little better than the index to boot. This is a very interesting statistic. All that work and effort! Quite what are we doing with our lives, and with other people's money? Please don't answer that just yet! One could compare market trough to market trough, broadly equivalent to our performance since inception (suspend judgement if you will and call today a trough) in which case returns are in the order of 10% per annum, and 9% per annum superior at Nomad compared to the average share or broadly a doubling in Nomad's share price whilst the index did nothing. That is more like it. And, it could be argued that since inception the price to value ratio of the partnership has been meaningfully lowered, implying healthy deferred returns to come. Even so, bear markets are tough and make you test the most basic assumptions. When moments like these arise grace under pressure all-round is the order of the day.

The following excerpt is taken from the June 2005 Nomad letter to Partners:

"*Zak and I concentrate on the price to value ratio of the Partnership and ignore its performance as much as is practical, and we would encourage you to do the same. In our opinion you should be more pleased with the improvement in the price to value ratio of the Partnership than the gain in the price of the Partnership this year. That's easy to say when results have been reasonable. But it would feel quite different if the Partnership had declined in price instead. Unfortunately nature does not always help us to think rationally. Psychologists (McClure, Laibson, Loewenstein and Cohen 2004) have found that the brain perceives immediate rewards differently to deferred rewards because two different parts of the brain are involved. Immediate gains are perceived positively compared to larger deferred gains as the limbic (survival) system has the ability to over-ride the fronto-parietal (analytical) system. Interestingly, stress induces this over-ride, and of course, money induces stress. So, the more stressed we are, the more we value short-term outcomes! This is not without reason, for if starving is a real possibility, a meal today is more important than a feast in a week's time, and the brain's wiring reflects that survival bias. Such notions are embedded in popular phrases such as "a bird in the hand is worth two in the bush". But at Nomad we try to be more analytical: it is the two birds in the bush we are concerned with and how they compare to the bird in the hand...It is price to value that's important.*"

Whether business values rise faster than share prices, or share prices fall faster than business values, either way the effect is the same: a growing differential between the price of a business in the stock market and its real value. It does indeed "*feel different*" when performance has been as poor as it was in 2008, but the rational mind will anchor on the notion that today the birds in the bush are very large indeed. It may not feel like it, but in many respects these are the best of times for an investor, and we shall lay out why in this letter. The reason opportunity abounds and there are so few takers (indeed the two are necessary bedfellows) is the headline to every newspaper, leads every news channel, is on the lips of every politician and we have all been subjected to so much economic prognostication that we will spare you its repetition here. Crises such as these do not reveal mankind at its best, far too much limbic thinking for our liking, and the sooner we can learn and move on the better. It does not feel like it, but crises like these are a force for good, and we will discuss this point too later in this letter. First, what can we learn?

Using up the Safety Net

One of the things this crisis reveals, at least in our opinion, is that there has been little give-in-the-system: that is to say, a lack of slack. Slack in time to think things through, or capital for investment for example. In a recent interview the author Nassim Taleb put it succinctly: "*Capitalism does not teach slack, it teaches optimisation*". That is capitalism teaches that assets must be worked hard, outputs maximised, returns as high as can be. We all see so much of this line of thinking that it has become part of the landscape so familiar as to not be noticed any more. Itineraries must be filled with meetings, school children's days must be filled with activities (I know my daughters' are), borrowing capacity must be used (or risk an "inefficient capital structure" – we have never really understood what that is), investors answer emails instead of listening to presentations, holidays are to be taken with Blackberrys rather than books, or nothing: outputs must be maximised today! And for most of the decade, there has been nothing as sinful in an investor's mind as money idly slouching on deposit, "*on the couch*" as the investor Seth Klarman put it. Instead cash must be put to work: its yield maximised. Indeed, and in the parlance of bond investors, "*chasing yield*" has been one of the maxims of the noughties.

Output maximisation looks efficient at least in the short term, but that is not the same as being long term optimal. The flaw to putting money to work immediately, for instance, is to presume that all relevant opportunity sets are available immediately. By accepting, say, a promoter's promise of eight percent returns (six hundred basis points better than money on deposit), the investor denies himself the right to future opportunity sets which may be far better, like public equity circa 2008 and 2009, we would argue. This is an easy concept to grasp when applied in hindsight, but much harder to see prospectively. A plan sponsor who argued that, contrary to the income statement, his cash was not earning two percent but ten percent (a blend of two percent on deposit now and twelve percent from an as yet undefined opportunity set sometime in the future) risks being perceived by his peers as away with the fairies – the lawyers and auditors would not endorse his view - but, he was right. That is why, in the hands of Warren Buffett for example, one could rationally argue that cash is worth more than cash. That is not an argument for hoarding cash, as many do today. For the cash to be worth more than cash it must be invested intelligently. It is, however, an argument for a cash buffer, just in case, a little slack in the system.

Charlie Munger, Berkshire Hathaway Vice-Chairman, was once asked how to get rich, presumably by someone of youth and modest means. Being of relatively modest means if not youthful ourselves Zak and I were keen to hear the answer: "*wait for an opportunity and invest the spare million dollars you have lying around*". What Charlie was telling us was that slack cash is worth more than cash. It was not what we wanted to hear. Now all we had to do was come up with a million dollars of slack cash!

A little slack would also have avoided fifty-to-one gearing ratios at the investment banks, burnt out school children, wasted holidays, and nothing-learnt business meetings. "*When someone says he is busy, he means that he is incompetent*", Nassim Taleb again, "*having a stupidly busy schedule isn't a sign of being important. It means that you have become insulated from the world*". And we wonder, if you are too "s*tupidly busy*" to think, which part of the brain is making the decisions? Not the rational outer cortex, we suspect. All this busy behaviour looks short term efficient (ten meetings a day!) but, in our opinion, the cost is that things are not being thought through; the end result of a thousand small steps in the current direction not assessed and long-term bad habits creep in. The biggest mistakes are the ones that did not look like mistakes at the beginning, after all bank robbers don't start out robbing banks, they pinch sweets, get away with it, and drift their way up. I suspect many robbers' behaviour latter in life would be inconceivable to them when they started. We all drift to some extent. Notice, for example, how company spokesmen use words. To hide reality, the embarrassed use acceptable words to replace accurate words. This is how companies end up talking about "*negative growth*" rather than declines, and how bank investor relations spokespeople talk of "*market turbulence*", when what they are referring to, we would suggest, is their own bad lending. If businesspeople are too busy to notice that their use of everyday language has drifted into, let's face it, low level lying, how were they to be honest enough with themselves to recognise the inevitable asymmetry embedded in securitised mortgages? All they were doing was making the next loan and selling it: No assessment of the destination of such behaviour required.

The thinking – or non-thinking – was contagious, and if it was good enough for bank X then it must be good enough for bank Y, and both companies reinforced these attitudes through quarterly reporting and annual incentives. The point is that the drift toward poor long-term outcomes is so much harder to spot if your reference periods are short, and one is too busy being busy to notice a lack of real world thinking. Many publically listed bank executives are certainly subject to these two factors. Is it any wonder these firms are at the epicentre of the financial crisis?

All this is a far cry from the early years of Rolls-Royce Limited, the manufacturer of motor cars, where Frederick "Henry" Royce made the engineers personally sign the parts they were responsible for making. That way, if any component proved faulty he knew who was responsible and he made them correct the fault in their own, unpaid time – *I paid you to make a working part, not a faulty part,* he would argue. And that is how he ended up making the best motorcars in the world. That level of personal accountability has been largely lost inside organisations today, and has instead been replaced with "*efficiency*" to the point of Taleb's *"busy incompetence"* and *"real world isolation"*. Zak and I do not see the ethics behind securitisation trusts, for example, building the reputation of any bank the way that Henry Royce's engineers built the reputation of Rolls-Royce, the manufacturer of the world's finest cars. What

passes for industry standard best practice today may look short term efficient but, in any lasting sense of the word, and from the perspective of the long-term business owner, it does not really get the job done.

The Case for Slack

We do try and run Nomad with some slack in the system. In the June 2007 letter to partners we suggested that one of the benefits of a long holding period was that it allowed time for gentle contemplation, to "*retreat and simmer*" a little, and we quoted the gardener Charles Jencks: "*understanding requires a certain slowing of time. Why else enter a garden?*" Notice, "*slowing*", it is important. Slack is provided in our company structure: Zak is perfectly capable of running Nomad on his own (*someone tell him I do! Zak*). This means that straight away we are running at something less than fifty percent capacity utilisation on a normal day, and so we can gear up, in effect, when opportunities arise as they have recently. Capacity utilisation is also kept low by few investments, held for long periods. We have had the blessing of learning some big lessons early in life (there will be more). And we have worked out that, in any real sense, we do not know that much. In our opinion we have the right environment to think things through, think rationally, and come to meaningful long-term insights. Whether our insights are economic or not will be our fault, it will not be due to the environment in which we work. Zak and I don't want to be busy; we want to be right.

Once it has been created, what is to be done with the slack? The best activities might be those that refresh the mind, broaden horizons and reinforce good habits, and it is in this spirit that I have become a governor of a failed school in south east London. What is interesting is not the reasons for the school's failure which seem common enough (unionised teachers employing 1970s teaching techniques, awful facilities and so on). What is interesting is the route out of the soup: incentives. Teachers who previously had no incentive compensation are being given bonuses for attendance (!) and improvements in class results. The children are being rewarded with house points for good work and behaviour, and deductions for poor work. But importantly, there are many more positive house points awarded than negative. This is a desire to be better system, not a punishment and condemnation system. There are other factors involved: new head teacher, new governors, school uniform, five-day teaching week (the previous failed school took Friday afternoons off – unbelievable!), but it is the incentives that reinforce the good behaviour. Other schools have undergone such a reformation with terrific results: for example at one south London school, which is run by the same team as my school, exam results for sixteen year olds have improved from a pass rate of 14% to over 90% in just over a decade. A good incentive scheme is so cheap compared to what is created.

Incentives. Incentives. Incentives.

In business the question then arises: what do incentives encourage? From the perspective of investors in Nomad, the incentives are helpful if they raise the probability of a favourable destination for our investee firms. Let's take the incentives around high low retailing as compared to scale economics shared retailing. Under the first strategy operating costs are generally high as a result of operating inefficiencies, and prices are high to compensate. To attract customers some products are reduced in

price on a temporary basis in the hope that whilst the customer is in the store they may buy some non-discounted items too (some prices are therefore high and others low, hence the name). The incentives here are awful: customers are trained to buy on deal, be disloyal and shop around, and for the retailer the inefficiencies of pricing and repricing and the volatility of volumes are meaningful. The effect is that, after adjusting for one off reductions in price, sales are lower on a normalised basis than they would be otherwise, which in turn exacerbates operating cost inefficiencies. Yuck.

Scale economics shared operations are quite different. As the firm grows in size, scale savings are given back to the customer in the form of lower prices. The customer then reciprocates by purchasing more goods, which provides greater scale for the retailer who passes on the new savings as well. Yippee. This is why firms such as Costco enjoy sales per foot of retailing space four times greater than run-of-the-mill supermarkets. Scale economics shared incentivises customer reciprocation, and customer reciprocation is a super-factor in business performance.

Scale economics shared works across industries too with the effect that load factors at the low price Malaysian airline, AirAsia, are superior to high-low flag carrying airlines. And it works online: Amazon have deployed it so well that Amazon's operating costs (per dollar of sales) plus its operating margin are less than some of its high street peers' costs (per dollar of sales). This offers the prospect that, in theory, Amazon's high street peers could price their products at net income breakeven and still not undercut Amazon's prices or profitability. For these high street competitors the game is over. They will leak revenues to more efficient rivals as customers respond to the incentive of consistently low prices and convenience. Over time high street rivals, and less successful online rivals, will need to restructure, change their product, or go out of business. We estimate Amazon's immediate hinterland of high street rivals have combined revenues of U$150bn in the US alone. If these firms go away over the next ten years, as Circuit City, Woolworths, Zavvi and others have recently, and Amazon picks up one dollar in ten of their sales, then this alone would be enough to quadruple Amazon's US revenues over the next decade.

Scale economics works well in bad economic times as well as good. On the busiest day in the run up to Christmas this year, order volumes at Amazon were 16% higher than the previous year, and note this compares to industry-wide US retail sales which declined nearly ten percent in December, according to the commerce department! And at AirAsia revenues per seat per kilometre flown rose 33%, whilst costs per seat per kilometre flown excluding fuel declined 10% in the latest quarterly period. Our businesses are surging ahead, even if, in some cases, their share prices are half what they were twelve months ago. In the last few months Amazon has been priced in the market as if it would not grow in the future, despite some of the best growth prospects we can imagine. That is a very rare combination and, combined with other similarly cheap stocks in the partnership, was the basis for Nomad's reopening at the end of last year.

Nomad Reopening

Whilst we had few redemptions as a result of the crisis, we also had few subscriptions. Indeed if one ranked the subscribers by size, Zak and I were the second and third

largest in October (!) and whilst it may have been a lot of money to us, it wasn't very much in the scheme of things! And still the opportunity set remains. The rational thing to do is to open Nomad whilst the price to value ratio remains very favourable and so, for the meantime, Nomad will remain open for subscriptions.

A Word on Zimbabwe

Richard Zeckhauser, at his brilliant behavioural finance course at Harvard, asks attendees to answer various questions to which they are not likely to know the answer, for example, the surface area of Norway. The answer is to be expressed in five numbers: a median best guess, two numbers which represent the 25th and 75th percentile of what you think the answer may be, and two more representing the 99th and 1st percentile of what the number may be. The more confident one is of the answer the more bunched the figures would be. The less confident the wider the distribution. So, for the size of Norway a student's line of thinking may be as follows: I'm not sure how big Norway is but it looks kind of smallish (first mistake, our minds may picture a globe as if we were looking from above the equator, this has the effect of visually squashing the landmasses toward the poles. If we visualised the world as if we were hovering above the poles, on the other hand, we may form quite a different impression), so, I think Norway may be 250 miles long by 75 miles wide say, or 18,250 sq miles. I cannot be out by that much (oh yes you can) so I'll double and halve my best guess and that will be my range, so Norway is no bigger than say 40,000 miles and no smaller than 10,000 square miles, and I'll halve and double those answers for the 99th and 1st percentile. Turn to the end of this letter for the actual answer (but watch out, even the fact that I have lead you through a worked example may effect your thinking!). It is a great test, and what it reveals is that, in aggregate, we tend to be far too confident that we know the answer to something that we don't.

If you had asked us for the range of possible outcomes to events in Zimbabwe we would have given you a very wide distribution indeed, from immediate international rehabilitation to, well, continued looting, and I do not think our distribution would have been wide enough (Zak now tells me he forecast events exactly!) Most recently, the factor that effects Nomad is the suspension of trading on the Harare Stock Exchange. The market is not suspended as such, but as all the stockbrokers have failed to meet the minimum regulatory capital required by their licenses, this applies even to the international banks, the exchange might as well be suspended. The reason for the sudden impasse is that the settlement period for transactions in the banking system as a whole has been extended enormously as investigators, responding to the alleged presence of fraudulent cheques, have chosen to, perhaps personally we don't know, check the cheques in the banking system themselves. Nothing is settling or clearing in a hurry. As a concession to the stock exchange, the authorities have allowed the brokers to trade, but only if the Chairman of the custodian bank, in our case Barclays Plc., personally underwrites settlement in the event Nomad fails to deliver. Hmmm. We have not placed a call to Mr Agius yet, or his CEO, John Varley, but we are not optimistic of a favourable response. As you may imagine, the financial system has stopped. And if there are no prices on the stock market, we cannot price our shares, nor price the unofficial exchange rate for the Zimbabwean dollar. We have no idea when trading will resume, it could be quite a long haul, and so the independent directors of Nomad's General Partner have taken the view that our Zimbabwean holdings should be valued at zero, as compared to 0.28% of Nomad at

the end of November. Zak and I don't think our businesses are worth nought, indeed we know they are not but, then again, we cannot give you anything for your Zim shares either. So, for the meantime, zero it is.

Happier Times.

Let me finish with a story told by the radio presenter and car collector Chris Evans that has parallels to the stock market bargains of today and helps demonstrate the merits of doing some proprietary work, sniffing out a great investment, and holding forever. First a little background. In the late 1950s Ferrari motor cars successfully competed and won almost all the major GTO class races of the time, but by the early 1960s they had started to lose ground to new slippery shaped Aston Martins and the AC Cobra, amongst others. The solution was Ferrari's first wind tunnel designed car: the 250 GTO, which was launched in 1962. It was an instant success, and beautiful to boot. 250 GTO owner Paul Vesty recalls childhood memories of seeing five GTOs line up on the start of the Goodwood TT in Sussex, England "*immediately all the other cars looked ancient – instantly we all wanted one*". The car won almost everything going, and became an immediate classic. It was also very rare: one hundred cars should have been built to qualify the vehicle for GT class racing but, in the end, only thirty-six were actually produced. The effect today is that fifty and sixty year olds, looking to buy their boyhood dream car, may have to pay world record prices, think U$10 to U$15m, the next time one sells at auction. After some successful seasons the GTO was replaced with faster models and during the mid 1960s Ferrari sold off its racing vehicles to enthusiasts. At about this time the third James Bond film, Goldfinger, was launched which featured the now iconic Aston Martin DB5. Back to Evan's story:

[In the mid 1960's]*"a very famous collector, who has one of the finest noses for sniffing out a deal, hears a whisper that the first James Bond Aston Martin DB5 may be for sale…The word is that for the right money, the original James Bond car can be bought directly from the movie studio. So he makes a few calls, he tracks down the production guy,*

"It's gonna have to be 15 for the pair"

"You mean there are two?"

"Hey man this is show business, there is always two…at least"

"But 15 for the pair" says our man. "I wasn't counting on spending that much and I don't really want two – I just want one"
"Well that is the deal. Take it or leave it".

Fifteen thousand pounds – a lot of money now, a load of money then. Our hero hesitates for a moment, but his nose knows better. It tells him to deal. He buys the car. The cash is to be paid on delivery of both vehicles. The day arrives, the trailer pulls up, the cars roll off. The invoice reads: FIFTEEN HUNDRED POUNDS. Yes friends both original Bond cars for £1500, but it does not end there. Be prepared to run for the hills screaming. Our man then swaps one of the Bond cars for a GTO. That's a GTO for £750. That's the cheapest GTO ever and…he still has it today."

Of such stuff are dreams made. Now, let me rephrase this story from the perspective of an equity investor. The collector thought outside the box, rolled up his sleeves, did some proprietary analytical work, and found a contrarian investment opportunity with great growth potential that few of his peers recognised at the time, lucked into a low price, owned it for ever and in the end it did not matter what price he paid particularly, as the growth in underlying value made his purchase one of the best investments of all time. Zak and I aspire to such a road map.

Thank You

To your eternal credit, Nomad's quirky approach to investing is respected by Nomad's partners. I do not think we have done our investors many favours as judged by Mr Market's erratic marking of our investments last year and indeed our own avoidable mistakes such as those discussed in the last letter. Be that as it may, we have had no enquiries as to performance during a year in which Mr Market and the media gave you lots of provocation. Net redemptions due to the crisis were less than two percent of the Partnership. Indeed we received some lovely notes of support during the year, which are special to us, and mean more than funds under management any day. Thank you. Please do not underestimate the value of your considered patience and support to the Nomad ecosystem.

The commentary in the press is uniformly gloomy and this is serving to depress share prices. What we know is that prices are lower than a few years ago and corporate behaviour is improving. We mean no disrespect to those unfortunate enough to lose their jobs, or caught up in other people's too-busy-to-think mistakes and scandals, but from the perspective of an investor there is less to worry about today than there was a few years ago. Indeed I doubt that worrying is the solution to anything particularly: far better planning. We are reminded of Winston Churchill's story of a man on his deathbed: *I have had a lot of trouble in my life*, says the dying man, *most of which never happened*. It may not feel like it but for a long term investor this is the best of times not the worst. It is in this environment that people sell their GTOs for £750. Take heart and look to the horizon.

Yours sincerely

Nicholas Sleep

The surface area of Norway is 148,746 square miles, according to Wikipedia.

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Nomad Investment Partnership

Interim Letter
For the period ended June 30th, 2008

To June 30th, 2008	Nomad Investment Partnership *	MSCI World Index (net) US$
Trailing:		
One year	-18.2%	-10.7%
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Four years	47.3	42.1
Five years	107.8	76.1
Six years	155.6	71.9
Since inception (Sept 10th 2001)	193.0	62.5
Annualized since inception		
Before performance fees	+17.1%	
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2002	+1.3	-19.9
2001 (inception Sept 10th 2001)	+10.1	+3.6

Since the beginning of the year limited partnership interests in the Nomad Investment Partnership and shareholder interests in the Nomad Investment Company have declined around twenty percent in price and means that a dollar invested in the Partnership at inception would now be valued at around two dollars and ninety-three cents. As usual we quote performance before performance fee payments, as Nomad's time dependent hurdle means that investors with different purchase dates will also have different net-of-all fees experiences. The subtraction of performance fees from the figures above means that, whatever the experience, it will be less favourable than those presented. The sole exception being the first six months of this year, when the refundable performance fee reserve was, indeed, refunded to the credit of limited partners and shareholders. In effect, investors as of January 1st got something back, and that something was a gain of around two and a half percent of net asset value (NAV). At the end of 2007, that same two and a half percent of NAV looked like performance fees in waiting to be paid to Zak and I over time. Today, if you were with us on January 1st, it sits in your account. This equitable system might be good for the soul, but it is not great for cocktail party bragging rights – Zak and I look at our shoes as we are asked "let me get this straight: you paid money back to your clients?" Whilst we don't care particularly for our peers' approval, we are working hard to at least be able to look them in the eye. And there is only one-way to do that: better performance over time.

All this compares with an index return of around minus eleven percent, and means that a dollar invested in the markets at Nomad's inception is worth around one dollar and sixty-two cents today. We were a little surprised to discover the index had done so well when some of the country indices are down between thirteen percent (for the S&P500) and twenty-four percent (for the DJ Euro Stoxx 50, in local currency terms, source, Bloomberg), although the weakness of the dollar means that returns to a US investor from assets held abroad will be somewhat better. Our curiosity for decomposing index returns, fleeting at the best of times, was tempered by Morgan Stanley's request for a subscription fee to unlock their index composition methodology. Too expensive at any price was our conclusion; it makes little difference to us what the indices are doing, and we decided to save the money and keep expenses down. Index envy is not a route to outsized returns and at the end of the day it is blindingly obvious that our relative returns are what they are because we don't own what everyone else is chasing, but more on that later in this letter.

Not since the Asian crisis do I think that Zak and I have been so "wrong", as measured by subsequent declines in share prices, so quickly after purchase as we have been in the last twelve months. We consider ourselves contrarian, value based investors. Ordinarily what we are buying is hated and reasonable value. When investments go from hated and reasonable to despised and cheap something is normally up in the markets. And what is up will be the subject of this letter.

In our experience investment managers tend to discuss individual stocks as a marketing tool. People like stock names. Others do not discuss stocks at all, either they understand the powerful psychological reasons for not doing so, or perhaps own shares for such short periods that there is little to be imparted. We would like to aim for a third route. I came across this Chinese proverb in a cookbook, of all places, but it sums up our approach to imparting information: "*Tell me and I'll forget, show me and I may remember, involve me and I'll understand*". It is in this spirit that we will discuss three recent "wrong" purchases, of firms in three different industries on three different continents. (It seems our deft, kiss-of-death-purchasing-skills know no industrial or geographical bounds. A note to company management: if you receive a call from us asking for an exploratory meeting with a view to Nomad making an investment and you care about your stock's short term performance – don't take our call!) In this letter we will describe the greatest source of risk (as we define risk: the permanent loss of value per share) in the portfolio today. Finally we will discuss perhaps the most important issue for all investors: duration – or, to put it another way, knowing who you are. First of all, let's illustrate the state of the portfolio with three stock examples. Nomad is the largest foreign shareholder in the first; the largest overall shareholder in the second, and Nomad is no longer a shareholder in the final company, although it was during the last six months.

Air Asia, Games Workshop and MBIA

"There must be some way out of here, said the joker to the thief,
There's too much confusion, I can't get no relief.
Businessmen, they drink my wine, plowmen dig my earth,
None of them along the line know what any of it is worth."

Source: "All Along the Watchtower"
from the album "John Wesley Harding"
by Bob Dylan, 1967.

Air Asia is Asia's largest low cost airline, and is probably the lowest cost airline in the world. The firm has borrowed heavily from Southwest Airline's model of operations (a point to point network configuration, on-line ticket sales, no reserved seating, one plane type). The effect is that costs including fuel are around 3c (US) per seat per kilometre (as of December 2007). Costs are very important when the product is, more or less, an undifferentiated commodity, and 3c compares with around 4.5c at Ryanair, 5.5c at Southwest or more importantly 4.5c at rival Malaysian Airlines. This cost advantage is shared with the customers in the form of low fares, although the firm has borrowed from Ryanair as well who extended the Southwest model to include revenue enhancements such as sales incentives for cabin staff, ancillary products and charging for complexity such as multiple bags. Even after allowing for these add-ons average revenue per seat kilometre at Air Asia is less than costs per seat kilometre at

Malaysian Airlines! For example, our first enquiry on-line revealed that a flight between Kuala Lumpur and Bangkok, a distance of 730 miles (roughly the same as New York to Chicago), one way, booked a few months in advance can be had for M$75, or U$22. That's U$8 per ticket cheaper than Malaysian Airline's super discounted fare, or U$120 cheaper than the normal Malaysian fare. The product is relaxed and cheerful and the image is not unlike the early days of Southwest Airlines when "*Southwest's low fares and service were as outrageous as its uniforms*", (source: "Nuts! Southwest Airline's Crazy Recipe for Business and Personal success" by Freiberg and Freiberg), although Zak tells me the knee-length, high-heeled boots worn by 1970s Southwest cabin staff were not evident when we visited Air Asia (and boy, did he look!). The customer, unsurprisingly, reciprocates, and the planes run (in airline terms) full.

Air Asia is an example of scale-economics shared, which like Amazon, Costco, Carpetright and elements of other businesses in the portfolio (Geico, Nebraska Furniture Mart) have come to dominate Nomad (around 45% of the portfolio). Air Asia is the first sizeable, professional, entrepreneur owned and run low cost airline to operate in Asia and as the firm began operations in 2002 these are pioneering days. For example, we do not know how big the market for low cost travel is in Asia, although U$22 to Bangkok strikes us as market stimulating. Joint venture operations in Thailand and Indonesia offer a population base seven times the domestic Malaysian market and it is for this reason that the firm has 175 A320 aircraft on order. The negotiated price of the A320s is, as far as we can tell, the lowest price paid by anybody for A320s and the firm has secured a guaranteed lowest price for an Asian carrier from Airbus for its planes. On paper then, Air Asia could be the most fantastic business.

But there are wrinkles: funding for the new planes is not entirely secured, and lenders are twitchy. 175 aircraft is a huge amount of capacity (one third the size of Southwest which has been in operation for 40 years). Asian nations all feel they must have a flag, a song, a national car and a flag carrier. Malaysian Airline Systems, long the government supported inefficient flag carrier is resurgent and is leading a price war. Oil is U$140 a barrel.

Even so, the firm earns a reasonable spread over the cost of capital on its aircraft, whilst forcing pricing on other airlines which leaves them operating at sub economic returns. This is a powerful combination and implies that the business will win in the marketplace in the end. We have no ego invested our analysis (at least, I don't think we do: if you want to make rational decisions leave your ego behind), outcomes are leveraged and perfectly reasonable people could come to different conclusions as to the firms investment merits. However, we do struggle with the price of the shares in the stock market today, which appears to value the firm at a meaningful discount to the value of the company owned fleet of planes. In short, the market has concluded that Air Asia, despite the potential outlined above, should not exist. This is nonsense; as such a valuation would imply that Southeast Asians, who are some of the most price conscious people on the planet, don't want cheap airfares!

Games Workshop

Games Workshop makes, distributes, retails and fosters the Warhammer family of tabletop games, think: modern equivalent of tin military soldiers. It is the largest firm of its kind in the world, although this is a small, but growing market. The customers are mainly boys between the age of 11 and 14 (no longer children, but before an interest in girls takes over!) and growth comes, in part, from word of mouth. Hobbyists must have the same soldiers as each other to comply with the stories that surround the battle scenes (otherwise, why are these sides fighting?) and so Warhammer is a standard and, if you want to play with your friends, you have to come to our shops. The firm grew steadily and profitably, if unspectacularly for many years until, that is, the Lord of the Rings line of models. These were very successful from the perspective of revenues and cash flow. However, windfall Lord of the Rings profits were invested in huge manufacturing facilities (that now run at 30% utilisation), funded new shops in marginal geographies, and a general complacency with the business set in, as the following excerpt from the Chairman's preamble to the 2007 accounts makes clear:

"So who was the enemy?

Is the world turning in such a way that mankind no longer wants or needs hobbies? No. All the evidence I see, with growing prosperity and increasing leisure time, is an increase in hobbies. Perhaps it is just collecting, painting and wargaming with miniatures that is passé? The evidence again says no. Too many of our stores around the world and their neighbouring independent accounts are in good healthy growth for that to be true. Have computer games, and especially these new online role-playing games, finally bitten Games Workshop? We have lived in happy harmony with computer games for our entire business life, our customers play computer games (they also eat meals and watch movies) but not at the expense of their hobby. The recent extraordinarily popular MMORPGs [massively multiplayer on-line role-playing games] would not, I think, have trimmed a little from us at the edges had they been in direct competition, they would have wiped us out. Are our overheads killing us? Well, yes, they could have, but they don't stop us selling things. Is it a change in society? No. Demographics? No. World recession? No, no, no. It was us.

We grew fat and lazy on the back of easy success. We forgot about customer service and forgot that hard work is and always has been the route to success. We forgot that we are a company which pursues profit and likes paying surplus cash to its owners. What was not expected was that it would take two poor years and a management reorganisation to get the problems taken seriously. Somewhere along the line too many of us thought that selling, sweating and saving were someone else's job. Well they aren't. That's my job and the job of all of us here at Games Workshop."

If the problems are self-inflicted they are usually within the powers of the firm to fix. According to the Chairman the firm is "*seriously well funded*" and this implies that free cash flow will be meaningfully in excess of net profits and will rise faster than revenues: all good then, for prospective profitability. Even so, the current valuation implies that the firm is worth little more than its investment in plant and equipment. To put it another way, like Air Asia, the market is saying that the company should not

exist. We will leave it to the parents to break that news to their Warhammer-playing sons.

MBIA

The Municipal Bond Insurance Association (MBIA) is the largest bond insurance company in the world. Insurance is provided against the principal and interest payments of a bond in the event of non-payment by the bond issuer. The recent problem has been that when premium prices declined, the Municipal Bond Insurance Association did not stick to municipal bonds and began underwriting the losses of other types of credit, most notoriously bonds issued against, not the tax raising powers of a municipality, but the static value of securitized mortgages. Well, it has been a perfect disaster. We purchased shares after the firm took a sizeable write down on its equity value, raised capital twice, changed management and after new management bought shares themselves, and that has been a disaster too (as judged by the subsequent decline in the share price). Much of the debate has centered on the size of the credit losses, whether they are U$2bn as indicated by the firm, or U$6 to U$8bn as indicated by some skeptics, or U$13.6bn as implied by Moody's worst case scenario, or greater than that as implied by the stock price discount to the firm's claims paying resources. There would appear to be considerable leverage to the upside considering the current market value, however we question our, indeed anybody's, ability to so finely judge the losses on U$680bn of insured assets. Both sides (longs and shorts) will think they are right, and it is perhaps the insecurity of their own positions that leads both to assert their cases so vocally in the media, at investment conferences and on the internet.

Whilst our interest was peaked by the stock's apparent discount to anything but the worst-case loss scenarios, in other words the odds looked attractive, the investment case from our perspective was somewhat different. The market value of the firm approximated the capital retained at the holding company and readily distributed from the insurance subsidiaries and attributes de-minimus value to the in place insurance contracts written by the subsidiaries. The possibility exists therefore for a new insurance firm to be set up separate from the old. The old can be left in runoff with any eventual surpluses used to fund share repurchase at the holding company or new business at a subsidiary level. So, at first blush there appear to be lots of options open to the firm, but to understand why we sold our MBIA, one must first discuss dilution risk.

Dilution Risk

Dilution risk occurs when companies issue equity at less than the firm is worth. This risk is always with us, but is most pernicious at stock market troughs. Let's take a, not wholly, theoretical example: a firm is worth, under normal market conditions, say U$2bn, divided by 60m shares or U$33 per share. A value-oriented buyer may start to buy shares at around U$15, thinking he has bought dollar bills for less than 50c. But what if the firm issues say, 30m new shares at U$10 to fund U$300m of cyclical losses. Under this scenario intrinsic value per share, adjusting for the U$300m in loses, falls from U$28 to U$22. Purchases made at U$15, thought to be at 47c on the dollar of value, turn out to have been made at 68c on the dollar. Worse still, dilution risk accelerates as the share price declines: if the firm raises the same amount of new

capital (U$300m) at U$5 per share, then intrinsic value after the capital raising falls to U$16 per share; and if capital is raised at a price of U$1 per share then intrinsic value afterwards falls to U$5.50. In the final example, original purchases made at U$15, at what was thought to be less than half value, end up proving to have been made at three times intrinsic value! Investors can protect themselves from this risk by putting in their proportional share in any new capital raising. The problem comes when investors start to question the size of the capital raising. Perhaps the firm needs more than U$300m? Is the business really worth U$2bn? How can we know for sure? The doubt manifests itself in further share price declines and increases the dilution from not participating in a capital raising. Dilution risk comes from doubt about one's original analysis.

Short sellers know this and whilst it is tempting to criticize their widely circulated 150 page marketing documents (it is interesting that, in contrast, the longs tend to keep their best ideas to themselves), the shorts' regulated anonymity, their desire to keep the doubt going and create an outcome (i.e. share placing) what the shorts are really testing is the shareholders' conviction, and on this level, in our opinion, institutional holders also have much to answer. For example, dilution risk virtually disappears if large institutional shareholders backstop capital raising at reasonable prices. This would require a firmly held view of what a company is worth, shareholders and management that do not game the system (rarer than hen's teeth) and is best done, in our opinion, by way of rights (with rights not taken up underwritten by large holders). Take for example the arrangement between Assured Guaranty and Wilbur Ross. It appears that Ross has agreed to provide up to U$750m to the company as, when and if the company requires. Management are free to raise capital elsewhere if they choose. In effect, Ross has gone a long way to under-writing the equity value (although not entirely) and for the time being the shares trade around book value. None of the other bond insurance companies, including MBIA, have this arrangement and all trade well below book.

The shorts know the institutions are weak minded. And the institutions themselves know they are weak. They are weak because, although equity is permanent capital, the owners of the equity are short term oriented. Institutional money managers appear to reason: why take a stand today when the shares could be half this price if I wait, and why buy shares today when I might get some shares in a placing at an even lower price? It is as if they suddenly do not know what a firm is worth. In taking such a timid view they sell their investments, themselves and their fellow shareholders down the river. Worse still, the preference in the United States for placings over right issues (gosh, the investment banks are good at marketing) means that current shareholders can be cut out of the capital-raising loop entirely. Under this model of stock market participant behavior the early contrarian buyer, who by himself is too small to influence the outcome by providing the capital required, is severely punished. So, however cheap MBIA may appear, the prospect of a future capital raising means that one cannot place a valuation on the business per share without knowing the number of shares outstanding, and we cannot know that until we know the size of the losses and the price of any future capital raising. In this Alice in Wonderland world, the stock's biggest attraction, its apparent cheapness, becomes the investor's Achilles heel, and it was for this reason that we sold our MBIA shares. And it is also for this reason that recent purchases by Nomad, which are not enough to recap businesses in their own right, and where there is meaningful dilution risk, have been modest in size.

So where have all the long-term investors that could be backstopping businesses gone? In our opinion, what we are witnessing is the effect of a generation or two of the ascendancy of the marketing people and risk managers in the investment management function. The business model at many firms is not to make investments, to research and provide permanent capital; instead the business model is to gather and retain assets. Fund managers at such organizations may have a strong financial incentive not to stick their neck out, and instead wrap themselves in a grey cocoon of rented stock portfolios. In other words, the marketing guys have won. When I described this conclusion to one fund manager he replied "*but, dear boy, they always do*".

Duration

Tom Stoppard, the playwright, is credited with saying "*If an idea is worth having once, it's worth having twice*" and it is in this spirit that we will quote Jack Bogle's work again. Investment holding periods by institutional investors have declined from an average of seven years in the 1950s to less than a year by 2006, according to the Bogle Institute. Well, I am sure Jack and his colleagues are right, but we can't see it in our investments. The average holding period for the US stocks held in Nomad (excluding Berkshire Hathaway) is fifty-one days! That is approximately one twenty-fifth of the time that we expect to hold an investment. Those that set the current prices for our investments (the renters) cannot have an eye on long term value, and that, in a nutshell, is the investment case for Nomad.

And that raises an important point: the costs of short-termism, such as dilution risk, are borne by investors when management mark the share price to market and issue equity. In other words, it is borne early in Nomad's expected holding cycle. The gains from short-termism, such as our ability to purchase shares for meaningfully less than they are worth, will take far longer to materialize. In the example above, the buyer of 10% of the company at U$15 a share and 10% of the capital raising at U$1 per share would in the end see an overall profit of U$80m on his U$120m invested, even though his book loss at the time of the capital raising would be 93.4%! It is pain today, and gain tomorrow. Our misanalysis of dilution risk at MBIA for example has cost Nomad investors about 1.5% of NAV this year, but the gains from our continued investment in Air Asia will, we expect, earn Nomad investors 20% of NAV in years to come.

Jack Bogle refers to his senior thesis at Princeton University regularly, even though it was written in 1951, and did so again in the following excerpt from a speech given to the Haas School of Business at the University of California in October 2006:

"Then, prophetically, Lord Keynes predicted that this trend would intensify as even 'expert professionals, possessing judgment and knowledge beyond that of the average private investor, would be concerned, not with making superior long-term forecasts of the probable yield on an investment over its entire life, but with forecasting changes in the conventional valuation a short time ahead of the general public.' As a result, Keynes warned, the stock market would become 'a battle of wits to anticipate the basis of conventional valuation a few months hence rather than the prospective yield of an investment over a long term of years.'

"Simply put, what went wrong was a pathological mutation in capitalism—from

traditional owners' capitalism, where the rewards of investing went primarily to those who put up the capital and took the risks—to a new and virulent managers' capitalism, where an excessive share of the rewards of capital investment went to corporate managers and financial intermediaries."

Be that as it may, and although we are financial intermediaries ourselves, we don't like it. One reason we don't like it is we cannot for the life of us figure out why society at large is served by having company owners swap seats every few months? We all know it is pursued in the name of the efficient allocation of capital and liquidity, but it fails at the former and the latter is prized by the insecure. Has this reached an extreme? We do not know, but we did enjoy the following exchange between an analyst and the CEO of one of our investee firms recently:

Analyst: *Was the exit* [in terms of business performance] *from March stronger or weaker than the entrance?*

CEO: *Sorry this is getting ridiculous, next question, please?*

It is not our system. The point of equity is that it is the only permanent capital in the balance sheet. It is there to weather storms, such as the current economic backdrop, and provide a stable base, and of course to earn the rewards of enterprise. This basic building block of society is broken when those with their hands on the permanent capital change their minds with their underwear. It is no coincidence perhaps that pass-the-parcel and musical chairs are children's games.

Charlie Munger described an alternative model at this year's Wesco Financial annual general meeting. According to Munger the English establishment was so outraged by the speculation of the South Sea bubble and subsequent share price collapses, that in the early eighteenth century Parliament passed the Bubble Act, which outlawed the issuance of shares! That ban remained in place for over a century (1720 to 1825) and, it could be argued, during that century Britain set the stage for the Industrial Revolution, the greatest step forward in modern society. It is not clear we need to trade shares to be successful.

But trade shares we do. According to Empirical Research Partners, an independent investment research firm, the current period is the greatest momentum market since the dot com era, which was one of the greatest momentum markets on record. (A momentum market is one where the best performing stocks this month were those that did best last month and so on. It is unusual because rationally one would expect shares to become less attractive as prices rise. However, currently investors chase stocks in order to own today what they should have owned yesterday. In effect prices rise just because they have already risen. Economics students will recognise this as a "Giffen good").

It is unusual for investors to repeat the last mistake (dot com behavior) so soon. Psychologists argue that the last mistake is so vivid that, if anything, we tend to over-correct, as anyone with a whisky-hangover will tell you. The insanity of bubble-like valuations was well captured by Scott McNealy in a 2002 interview in Business Week when he was still CEO of Sun Microsystems (source: James Montier, Société Générale, Cross Asset Research Group),

"But two years ago we were selling at ten times revenues when we were at U$64. At ten times revenues, to give you a ten-year payback, I have to pay you 100% of revenues for ten straight years in dividends. That assumes I can get that by my shareholders. That assumes I have zero cost of good sold, which is very hard for a computer company. That assumes zero expenses, which is really hard with 39,000 employees. That assumes I pay no taxes, which is very hard. And that assumes you pay no taxes on your dividends, which is kind of illegal. And that assumes that, with zero R&D for the next ten years, I can maintain the current revenue run rate. Now, having done that, would any of you like to buy my stock at U$64? Do you realize how ridiculous those basic assumptions are? You don't need transparency. You don't need footnotes. What were you thinking?"

More to the point, what do they continue to think? Why has, say, Potash Corporation of Saskatchewan, a miner of potash and manufacturer of fertilizer (share price up ten fold in three years, to twelve times sales) taken over from Sun Microsystems, a manufacturer of servers (share price up ten fold in the two years to 2000, peak valuation around ten times sales)? The answer, along with an unshakable belief in the sustainability and longevity of Chinese urbanization, emerging market demand, resource booms, search for inflation hedges and so on, may have something to do with the decline in investor time horizons – the average holding period for shares of Potash has declined from nearly two years to six weeks as the share price has risen, and if you own the shares for just six weeks, then what do you care if, in two years time, current prices turn out have been a bubble? Lord Keynes was spot on.

Rules, Roundabouts and IFRS 7

Even though the partnership has lost money so far this year, Zak and I have almost no stress from investing. All our stress comes from the business side of the operation: that is compliance, reporting, auditors, accounting and so on. Take for example IFRS 7, which requires directors to describe the risks embedded in their operation and how they manage those risks. At first blush this seems like motherhood and apple pie – who could argue with that? But let's take Nomad. The risks the accountants are concerned with are, predominantly, interest rates, currency and credit risk, which is sensible enough. But then they ask, not how we manage these risks over the holding period of an investment (say selling foreign currency to match the expected five year holding period of a foreign stock) but how these risks will be managed in the next 12 months! In effect the accounting rules ask how do we manage the risk that interest rates will rise in Thailand in 2008? On many of these issues, in the context of our investment time horizon, we don't see the point. If interest rates do rise in Thailand in 2008, then the short term prospects for our shopping mall, Mah Boon Krong Holdings, may temporarily decline, but it is far from clear that that event is a risk to business value in five years time. Indeed it looks like an opportunity to us! In other words, the accounting tries to bend Nomad out of shape. So all is clear, Zak and I see our job as controlling the risk of mis-analysis of the big things – value per share of an investment many years out – not spotting wiggles on the path along the way. Everyone else does wiggle guessing.

Whilst we respect the intentions behind the rules, and our candid response is contained in note 4 of Nomad's accounts, one is left feeling the exercise has been nothing but a tax on time: a cost disproportionately borne by small investment firms; a

barrier to entry. It is partly through dealing with IFRS7 that the Nomad audit was completed at the end of June rather than earlier in the year.

In previous letters we have described the events that surrounded the flood in Carlisle, England a few years ago. Readers that make it to the end of our letters (there must be some) may remember that after the flood the main traffic lights on a busy two roundabout junction (grief, one roundabout on top of the other!) had failed, and that despite this, the police had allowed the traffic through, only for the town planners to discover that, months later, and with the lights still not working, the intersection was safer despite higher average traffic speeds compared to before the flood. One can imagine how we cheered at a recent newspaper article, which reported that the Dutch town of Drachten had borrowed a leaf from Carlisle's book, and removed most of their traffic signals. The project was the brainchild of Hans Monderman, a traffic planner who claimed in an interview that "*it works well because it is dangerous, which is exactly what we want. It shifts the emphasis away from the Government taking the risk, to the driver being responsible for his or her own risk*". Bravo, sir!

Should readers think that England is at the forefront of such open minded initiatives please observe the efforts of workmen in Coventry, England who recently built a roundabout and placed "no-exit" signs before every exit, with the effect that once drivers entered the roundabout, there was no way off! The non-thought of those following orders never ceases to amaze. There are two routes to follow in investing: Drachten or Coventry. And we are following Drachten. The future is uncertain, nothing is perfect, and Zak and I may make huge mistakes. And it is because of this risk that Nomad will operate at its best.

Momentum Investing Revisited

In December last year the contents of the Savoy Hotel in London were auctioned to the public. There were several interesting lots: silver trays, pepper and salt pots stamped with the hotel's insignia and so on, although one that caught my eye was a chrome wall protector in the shape of an 'S'. 'S' for Savoy, 'S' for Sleep (such vanity – first mistake), and well, I have always had a soft spot for the hotel (second mistake) and whilst I had no idea what the intrinsic value of such an item might be (third mistake), I placed a bid (fourth mistake). There were a dozen 'S's for sale with lots available over three days. On the first day the prices rose from £350 to £500. On the second day they started down a little at £400 but rose to £800. And on the final day they started at £600 and rose to £850. Notice that the lowest price of each day was the first price and how prices rose steadily throughout the three days. Why? The answer, it seems to us, is first, scarcity, as the auction continued the stock of available 'S's declined. Second, social proof, once one person had set a high price it was seen by others to endorse the value of the item and they too could pay a higher price knowing they were not alone. And what price did your author pay? Well, let's just say I bought on the last day…and I justified it by telling myself that it was a one off, the Savoy is special, I wont get this chance again, 'S' for Savoy, 'S' for Sleep, and so on. And I just know I overpaid (Mrs. Sleep's withering what-have-you-done-now-look said it all). We can all do momentum investing, but it is emotional investing and I just don't think it is that intelligent, or profitable.

Current performance notwithstanding, Nomad is in good health, despite our "senior moment" in mis-analysing dilution risk (Zak and my aggregate age is, after all, 79!)

Almost ninety percent of the portfolio is invested in firms run by founders or the largest shareholder, and their average investment in the firms they run is just over twenty percent of the shares outstanding. Fifty-five percent of portfolio companies are either repurchasing shares or have had meaningful insider buying. There is huge growth embedded in the portfolio and normalized profitability is high. Despite these attractive prospects the average investor rents shares in our firms for fifty-one days. They simply cannot be looking at what we are looking at. Our shares are cheap because investors prefer to chase the new booms surrounding Chinese urbanization and associated natural resources demand. We have no idea whether purchases of resource stocks at current prices will prove profitable for these investors. However we do know that our stocks are selling at bargain prices. Since September 2001 the Nomad share price has risen from U$1000 to around U$3000 today. Zak and I see our job as getting it to U$10,000 in time, and the current portfolio should get us substantially there.

There are times when it is easy to feel good about investing, and there are times when it is much harder. The emotions usually go with outputs. After Nomad's share price tripled, it was easy to feel that God was in heaven but, as prices decline, spirits sag. We would counsel you to think about the inputs to investing rather than the outputs. It is in times like these that the hard psychological and analytical work is done and the partnership is filled with future capital gains: this is our input. The output will come in time. Those with a rational disposition may not find it too hard to feel good today.

As always, we thank you for your confidence in us, and most of all, we value your quiet patience.

Yours sincerely

Nicholas Sleep

* Sleep, Zakaria and Company, Ltd., was appointed as investment advisor to the Nomad Investment Partnership with effect from September 12th 2006, replacing Marathon Asset Management who had been investment advisor to the Partnership since inception. Prior to this transition Nicholas Sleep and Qais Zakaria were responsible for the investment management of Nomad whilst employed by Marathon Asset Management. Partners should note that the very nature of the transition from Marathon to Sleep, Zakaria and Company, Ltd., means that the Partnership does not benefit from the same back office infrastructure support it used to receive. In this letter we use the term "partners" as a generic term referring to all Nomad investors, whether shareholders in the feeder fund (the Nomad Investment Company) or limited partners in the Partnership and not, in the strict, legal sense of the word, to imply the creation of a partnership between shareholders in the feeder fund, Nomad and/or Sleep, Zakaria and Company, Ltd.

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Nomad Investment Partnership

Annual Letter
For the period ended December 31st, 2007

To December 31st, 2007	Nomad Investment Partnership *	MSCI World Index (net) US$
Trailing:		
One year	+21.2%	+9.0%
Two years	37.7	30.9
Three years	50.4	43.3
Four years	83.6	64.4
Five years	229.7	118.8
Six years	234.0	75.3
Since inception (Sept 10th 2001)	269.0	81.6
Annualized since inception		
Before performance fees	+23.0%	
After performance fees	+19.1%	+9.9%

The figures above are unaudited, presented on a cumulative basis and, as ever, the results are presented before performance fees. We present results in this way as the time dependent performance fee hurdle means that partners will have different net-of-all-fees results. Below the same results are presented in discrete annual increments. In our opinion it is the upper table that is most useful in assessing long-term investment performance.

To December 31st, 2007:	Nomad Investment Partnership	MSCI World Index (net) US$
Calendar Year Results:		
2007	+21.2%	+ 9.0%
2006	+13.6	+20.1
2005	+9.2	+9.5
2004	+22.1	+14.7
2003	+79.6	+33.1
2002	+1.3	-19.9
2001 (inception Sept 10th 2001)	+10.1	+3.6

The effect of the performance noted above is that the value of a dollar invested in Nomad at inception would now be worth around U$3.70 before performance fees and just over U$3 after fees. A similar amount invested in the index mentioned above would be worth around U$1.80.

When I finish writing these letters I am happy with them, at least happy enough to send them out. I make a habit of re-reading them some time later and frequently they disappoint. It is as if the letters have a short shelf life. I am not sure they do go down hill particularly, it's just that they did not start that high up the hill in the first place: the mind thinks they are better when just finished than they really are. It is like the freshly painted wall, it looks good as you reach for the cup of tea at the end of the day, but give it a week and all you can see are the bits you missed.

The last letter, for example, is very complicated. There are many heavy concepts introduced one on top of another and it is hard going to read. This is particularly annoying as investing is, at its heart, a very simple discipline. Simple, perhaps, but not easy. And judging by my efforts, certainly hard to communicate. So why are letters more complicated than they need be? Probably because we feel a self-imposed pressure to say something, especially something new or (better and) impressive. The truth is that there is not that much to say, at least, not much that hasn't been said before. That's the curse of being two thousand years younger than Saint Paul, forty-four years younger than Charlie Munger and twenty-nine years younger than my father.

We will return to this topic later in the letter. Today, however, we do have something to add, at least we think we do, and the topic for this letter is mistakes. In this letter we will discuss how we think about mistakes, why the response to the mistake is often more important than the mistake itself, and some of our investment mistakes. We will then discuss why client reporting pressures encourage non-rational thought (a mistake in the making?), provide further encouragement to partners to focus on what we control, and announce a change in housekeeping that may be of interest.

How we think about mistakes.

"If I had to live my life again, I'd make the same mistakes, only sooner".

Tallulah Bankhead (actress).

In our opinion, in dealing with mistakes the best state of mind is non-judgemental forgiveness. Parents will recognise that if their child thinks right, they will make mistakes, work it out for themselves and learn. They do not need to be judged or punished: instead they need support, from themselves and others. If they do learn, then the mistakes are likely to be small compared to the value of what has been learnt. In investment terms, once lessons have been learnt, mistakes can be put on a price earnings ratio of one and the resultant, conditioned, good behaviour on a ratio of more than one. In other words, mistakes become net present value positive.

So why is it that investors are so unforgiving when a company disappoints? If we apply the model above then there is not a problem. If the market was rational and the company an organisation that learns, then the stock price should rise after a mistake. But this is seldom the way the world works. It is as if investors presume that companies do not learn from their mistakes. And that makes some sense, as many organisations struggle with rational behaviour. We wonder if investors' anger is a sub-conscious admission that they invested in a non-learning organisation? An unintended consequence of this is that the financial services industry is structured to allow the embarrassment, frustration and anger to vent through the various asset classes. It is structured to allow investors to be judgemental rather than forgiving. You can just hear people justifying their purchase of a gold fund because that idiot who ran their technology fund made a mistake. And he may have. However, if he learnt from his mistake then the value of the fund, properly calibrated, is likely to be rising just at the time investors are selling. There is not a lot of love going around, in the sense of love for one's fellow man, and because of this there is less learning than there could be.

That is not our model.

We (strapping on the protective armour of the first person plural) have made lots of mistakes. (I will be less cowardly) I have made lots of mistakes. Sometimes we made the mistakes ourselves. Sometimes we learnt from others. Sometimes they were direct investment mistakes. Sometimes they were part of growing up (look out for those private mistakes, they are full of investment lessons). But there they are. Warts and all. This is how life is. We do not justify them, but we do not condemn them either. Indeed, they are best not judged. Our model is to learn from our mistakes and what we learn we hope to give to you, in better performance results (in exchange for a performance fee!).

One way we do this is to practice what we preach, and invest in businesses that have made mistakes. Our current investments in Liberty Global, Games Workshop, Dell, Sony and Ford fit into this category, as do previous investments in firms in bankruptcy such as Telewest (now Virgin Media) and Calpine. For these investments to work over the long haul, what is required is a rational, honest mea culpa and a low share price. The unforgiving nature of the markets often provides the latter. The former is much harder to come by.

<u>Why the response is more important than the original error.</u>

> *"Life is ten percent what you make it and ninety percent how you take it."*
>
> William James (philosopher).

We all make mistakes. What is often more important is how one responds. Take for example the response of two firms to the same mistake. The mistake was to be caught out by the last major property downturn in the early 1990s. The two firms are: MDC a residential property developer, and a sizeable European bank with a large commercial property loan book which, being far better capitalised than SZ and Co, we will refer to as Bank X.

MDC was founded in 1972 by Larry Mizel with U$50,000 in capital. In the 1980s his firm built condominiums and apartments and as the property cycle matured reinvested profits and available borrowings in land for development. This is a classic property cycle error and dooms the purchaser to buying at high prices and leaves little financial flexibility during a downturn. By the early 1990s, revenues had almost halved from the 1988 peak and the firm was left with too much debt and tracts of undeveloped land. The firm averted bankruptcy by selling assets, issuing shares and repurchasing debt at cents on the dollar. The family learnt from its experiences and since then the land bank has been kept to a minimum, debt has been used with great reluctance, and equity capital freed from house sales has been used to equity fund the next venture, pay dividends or, to a greater extent, retained on balance sheet. Whilst management may have learnt their lesson it must have been galling to have pointed out by an investor at a recent presentation "*you are going to run out of land*"! Plus ca change. The MDC share price has risen ten fold in the last ten years, despite recent industry wide declines in share prices, and today the firm is one of the best capitalised in the industry. It will be interesting to see how they respond to the current industry crisis.

Bank X made similar mistakes in the late 1980s through extending loans to commercial property businesses, although here only a dividend cut was required to repair the capital deficit. According to a company spokesman the lesson learnt from the debacle was that the bank "*could not do commercial property*". Companies often misclassify their mistakes in terms of outputs rather than inputs, and in so doing allow the original mistake to go unchecked. Psychologists call this denial, and we all do it to some extent. But it was a false lesson. It was not commercial property per se that was the source of the losses, there is no a priori reason why a lending institution cannot make loans to commercial property as this bank continued to in say, residential property, or credit cards. In our opinion, the mistake was in how the company approached commercial lending: it was in how they thought and how senior management were incented to think. However, instead of responding to the mistake by rewiring the corporate cognitive functions the firm condemned the output and diversified internationally and developed investment banking and an investment management operation, as if to dilute the risk. This is a take-three-wives-just-in-case approach and it works in terms of corporate longevity but is rarely equated with share price success: in the trailing ten years the shares of the bank have risen in the order of ten percent, or around one percent per annum. A deposit account at the institution would have returned far more.

There is a second lesson embedded in the contrast between MDC and Bank X, and that is the popular wisdom that diversification lowers risk. This maxim, as homely as apple pie, is fraught with danger. Its ascendancy into the unchallengeable heights of received wisdom comes from the vivid image of seeing one's nest egg disappear because of one mistake. What is not recorded is the cost of the suboptimal outcomes that result from over-diversification which range from lack of investment work, high

fees and, most dangerous of all, complacency which allows one to ignore the only real, long term risk, which is the risk of misanalysing a company's destination. Take for example the salami slicing of loans that are embedded in securitisation trusts. Diversification used in this way tries to turn ignorance into an asset. There is something of the zeitgeist in this behaviour: companies routinely subcontract parts of their operation in the name of efficiency, in effect salami slicing their operations into narrow functions. This looks efficient, at least as captured by the profit and loss statements in the early years, but few firms ask: what is lost in this process? Sometimes what is lost is control of subcontracted operations such as Mattel's Chinese sourced toys, or the BBC's documentary of The Queen. But mostly it is a lack of trust in the institution by the customer and, unfortunately, this sentiment is often reciprocated. If you know a mortgage sold to you by a commissioned pimply youth now resides in one of many hedge funds' balance sheets you will feel differently about it than if your branch manager, who has known your Dad for fifty years, still has it on his books. And the pimply youth feels differently if all he has to do is sell your mortgage. Depersonalisation inevitably leads to customer disloyalty and commoditisation, and that is not good for long term profitability, regardless of what the profits account reads today.

How mistakes can become net present value positive.

"It is always a delight to observe other people's mistakes".

Anon
(Rather, I have not found the source before publishing!)

There is a philosophical argument that a mistake is only a mistake if you call it so, otherwise it is a learning opportunity. That seems like the right spirit to us. Our two biggest analytical mistakes (sorry, learning opportunities) to date were probably Conseco and Stagecoach. We have written about these errors extensively in the past, but in the spirit of the quote above I will précis: Conseco went bankrupt after losses in its manufactured housing loan securitisation trusts impaired capital at its insurance company and A.M. Best, the insurance industry rating agency, declared the business inadequately capitalised. Our analytical mistakes were multifarious, but the most serious was to anchor on analysis at the time of purchase to justify continued holding. The immediate dollar loss was around U$5m for investors in Nomad. However, the opportunity cost loss, the dollar loss adjusted for subsequent Nomad performance (a fairer reflection of real costs) is around U$10m.

Stagecoach was a success in the sense that shares purchased at 14p were sold at a high of around 90p. That is until one looks in the Financial Times to be reminded that the shares currently trade above £2.50. The mistake was to leave £1.60 on the table, and was also caused by anchoring on the original purchase decision analysis (which required a value above 14p), rather than thinking about the destination for the business in years to come. The opportunity cost of the Stagecoach mistake is broadly U$12m today (and counting).

The analytical mistake in both cases was to have a static view of a firm formed at the time of purchase, which failed to evolve as the facts changed. This error was reinforced by misjudgements such as denial (the facts had changed) and ego (we can't be wrong). There was also an over-reliance on price to value ratio type analysis,

which can encourage a tighter range of outcomes than occurs in reality. And what did we learn in Investing 101 from Lord Keynes: "*better to be generally right than precisely wrong*"! At the time we were making these errors we would have held Keynes' quote as true. One has to be so careful; sometimes these mistakes are very insidious. Keynes' dying words were reported to be "*I should have had more champagne*". No doubt he is right on both accounts.

Destination analysis is consciously central to how we analyse businesses these days. It helps us ask better questions and get to a firm's DNA. What we learnt at Conseco may well have kept us out of the US banks last year, and what we learnt at Stagecoach has helped us continue to own Amazon. These two benefits have been a combined gain in the order of U$60m during 2007 to investors in Nomad. The maths behind this assumption is a little finger-in-the-air and is unadjusted for subscriptions post mistakes, but it is directionally correct and implies that a large proportion of Nomad's performance in 2007 came from the lessons learnt from mistakes in 2003 and 2004. Think of it as a return on prior year losses. And that is just one year's gain. If we have really learnt our lesson, then the gains will continue in future years too. In the meantime we continue to bear down on denial and ego too!

Tips on how to avoid making mistakes.

Understanding how the intellect can become corrupted is probably a life's work, some mystics would argue many lives' work. Noticing the mistakes is a huge advantage and so rarely done. What follows are three mistakes that, in our opinion, contribute to more unhappy outcomes than most. These are: denial, that is the reinvention of reality in the mind because the truth is too painful to bear; anchoring, that is a static, historic vision of a problem; and drift, that is how small, incremental changes in thinking build into a big mistake. Add judging to the list as well, in the sense of condemning or exalting: that disposition stops a lot of rational thought, and it is almost ubiquitous. One of our favourite Buffett stories came from an interview with Walter Schloss carried in the Outstanding Investor Digest (June 23rd 1989, www.oid.com)

Walter: *"Warren (Buffett) was playing golf at Pebble Beach with Charlie Munger (Berkshire Hathaway vice-Chairman), Jack Byrne (Fireman's Fund Chairman) and another person. One of them proposed. "Warren, if you shoot a hole-in-one on this 18 hole course, we'll give you U$10,000. If you don't shoot a hole-in-one, you owe us U$10". Warren thought about it and said, "I'm not taking the bet." The others said, "Why don't you? The most you can lose is U$10. You can make U$10,000". Warren replied, "If you are not disciplined in the little things, you won't be disciplined in the big things"."*

I have thought about this story for years, and two things strike me: first, Buffett had to think about the answer, no doubt calculating odds and price. I am always relieved that Buffett's skills had to be learnt and honed, they were not simply innate! Second, Buffett recognised that little lapses in discipline themselves have implications: in other words, he was watching out for drift.

One trick to help see the world more clearly is to invert situations. A newspaper headline claiming that one third of the population wants something, also tells you that two-thirds don't! In our opinion, the best book to hone the skills of inverting was

written by Terry Arthur in 1975 and is entitled "95% is Crap – A plain man's guide to British politics". Terry is one of the most modest and thoughtful people Zak and I have had the pleasure of meeting, and he was one of the first investors in Nomad. Enclosed with this letter is a copy of the second edition of Terry's book, updated for modern crap. Once you have read this book, we promise you will not see presented facts the same way again. For those with an interest in such things, we purchased our copies at a discounted price on Amazon. We recommend you buy a copy for everyone you love, on Amazon too, of course.

Mistakes in the Making. Myth: Say-something syndrome lowers risk.

In John Rockefeller's biography, "Titan", Ron Chernow describes how Rockefeller equated silence with strength. In one incident Rockefeller was reported as saying that "*weak men had loose tongues and blabbed to reporters, whilst prudent businessmen kept their own counsel*". Standard Oil's acquisition led growth could be a problem therefore, as taciturn management could become diluted with a more loquacious, acquired intake. In one acquisition Rockefeller was therefore especially delighted to snare Charles Lockhart, a bearded Scot with a frosty manner who was, in Rockefeller's words "*one of the most experienced, self-contained men in business*". During negotiations to purchase his firm, Lockhart had listened attentively but hardly breathed a syllable. This elicited Rockefeller's highest praise, "*That kind of man I'd like to have go fishing with me*".

Taking a leaf from Lockhart's book, the question is, do Zak and I say too much? For example, it is interesting that two of the best performing funds of all time did not disclose their holdings to investors. These were the Buffett Partnership and Walter Schloss Associates, although Buffett wrote extensively about how he thought and approached investing in general. And it was for a good reason that they did not disclose their holdings, they did not wish to be judged, second-guessed or worse (!) as Walter Schloss revealed in the same interview with the Outstanding Investor Digest,

OID (interviewer): *Is it true that even your clients don't know what you're buying for them?*

Walter Schloss: *That's correct. And a little story might help explain why we don't tell them what we own. One of our partners said, "Walter, I have a lot of money with you. I'm nervous about what you own." So I made an exception and said, "I'll tell you a few things that we own". I mentioned the bankrupt rail bonds and couple of other things we owned. He said. "I can't stand knowing that you own those kind of stocks. I have to withdraw from the partnership." He died about a year later. That's one of the reasons we don't like to give people specifics."*

OID: *You should not blame yourself. He might have died anyway.*

(Then again, he might not!) Let's invert for a moment: when we think of our investee companies, the firms which we would quite happily own with no word from them for years are those businesses in which we have the highest confidence of reaching a favourable destination: they are the firms we think we know will work. They are also the largest holdings in Nomad. It is the less certain businesses about which we are more insecure that appear to demand more regular attention. If there is demand for our

holdings list, is that what our clients are sub-consciously asking? A bit of handholding please because the trust is lacking? And what does that say of the monthly reporting that passes for industry norm? Thank you for helping us avoid that mistake. Our six monthly writing may be as irrational as monthly reporting, but at what frequency does letter writing become rational? Presumably when one has something meaningful to say. Gosh, that is not very often! A Charles Lockhart disposition would argue for an ad hoc, rather than diarised, schedule to letter writing. Perhaps this is something to pursue in the future.

In previous letters we have discussed the dysfunctionality of disclosing specific investment ideas. The problems are mainly psychological and include the locking in of an idea, the desire to seem consistent, the wish to seem prudent in other people's eyes and so forth. There is then the effect of copy-cat investing, brokers trading against us and, as Walter Schloss found out, dealing with nervous-Nellies and so on. In this letter we have expanded on the topic somewhat.

It is tempting to see the free distribution of our holdings list as an unforced and unnecessary mistake, and so one course of action would be to stop sending them out. However, if we did stop that would also presume that the list was only used for the worst (and I have gone on about being judgemental in this letter already!). We know that some partners have a natural healthy curiosity to see how their money is being invested (if the tables were turned, we would too!) and Zak and I have learnt a great deal from reverse engineering others' holdings, and so we will continue to disclose our holdings, although under separate post.

We ask you to examine your motivation for studying our holdings list. If, for example, you think you are monitoring investment risk in monitoring the share prices of investee firms, then perhaps Nomad is not for you. In our opinion, transient, historic, stock price quotation volatility is not the same as investment risk. Indeed, quite the opposite. If, however, you study our holdings through a joy for the art of investing, our books are open to you (well, with a lag).

Investors will understand that the further distribution of our ideas is contrary to all partners' interests. As ever, our preference is that the holdings list remains private, and we remind you that the contents of these letters are not to be reproduced without permission. We do hope you understand.

<u>We focus on what we control.</u>

The following excerpt is taken from Reverend Norman O'Neal's account of the life of Saint Ignatius Loyola. Prior to conversion, Ignatius had been a soldier in the Spanish army and was injured in a battle with the French.

"During the long weeks of his [Ignatius'] *recuperation, he was extremely bored and asked for some romance novels to pass the time. Luckily there were none in the castle of Loyola, but there was a copy of the life of Christ and a book on the saints. Desperate, Ignatius began to read them. The more he read, the more he considered the exploits of the saints worth imitating. However, at the same time, he continued to have daydreams of fame and glory, along with fantasies of winning the love of a certain noble lady of the court. The identity of this lady has never been discovered but*

she seems to have been of royal blood. He noticed, however, that after reading and thinking of the saints and Christ he was at peace and satisfied. Yet when he finished his long daydreams of his noble lady, he would feel restless and unsatisfied."

Poor Ignatius. One can see how he is credited, by some, with the following prayer:

"Give me the strength to accept that which I cannot change,
The courage to change that which I can,
And the wisdom to tell the difference."

It is a very beautiful statement and is helpful in thinking about the Partnership. In our opinion, the biggest risk in investing is the risk of misanalysis. We seek to control this risk through the quality of our research, especially through applying what we have learnt. The quality of our research-based decisions overwhelmingly determines whether we will do well in the long run. But it has almost no influence over the timing of these results. Zak and I do not control the annual performance figures. It might be nice if we did. But we don't.

We encourage you to focus on what we control too!

To our partners great credit we have never had hand-holding requests and, with the exception of a friend of mine who studies share price charts rather than companies and shall therefore remain nameless, no redemptions. It would be wonderful if this was because our partners have a stoic indifference to short term results. And better still if this was because partners read our letters, know the philosophy and methodology of what we do, and know that this is the engine of future success.

Our aim is have the same relationship with partners during periods of poor performance as we do during the good times. And we aim to do this through encouraging our partners to focus on the things we control. That is quite a goal, and we understand that what we are asking goes against human nature. My father worked as a geologist for the Abu Dhabi Oil Company in the early 1960s, and the unofficial motto amongst the engineers there was "*aim high, and grab what you can as you fall*". It is in the spirit of aiming high that we ask you to focus on inputs rather than outputs. It is the rational thing to do. If we were all focussed on what can be controlled then that would be something special!

A trick to help the rational mind is to put our periods of good performance together with our poor performance. We encourage you to mentally shuffle the surplus from the good years and allocate it to the deficit of the bad years. Especially any future bad years, please! Better still; take away the adjectives used to describe the years. That way one can accept life as it is. After all, regardless of the order in which annual results fall, the destination will be just the same.

Housekeeping

Northern Trust has been appointed as custodian bank, the transition from the incumbent operative took place in November and it all went without a hitch. This completes the transition started two years ago with the replacement of the incumbent

administrator (the same provider) by the excellent folks at Phoenix Financial Services (do call Phoenix +353 1 845 8161 with your statement enquiries). Hopefully there should be little contact with Northern Trust, however, should the need arise, do call Marcia Denham on +44 207 982 2213.

Nomad means far more to us than simply managing a fund. As a younger man I separated investing from the rest of my life, as if they were different worlds. This is a false construct. Another mistake. What we learn from home-life helps us be better investors, and what we learn as investors helps us be better husbands and fathers. In the end, all reality has to respect all other reality.

Nomad is a rational, metaphysical, almost spiritual journey (without the sand and camels, although Zak may be happier with them). And that's what a full life is all about. Thank you for your support.

Yours sincerely

Nicholas Sleep

* Sleep, Zakaria and Company, Ltd., was appointed as investment advisor to the Nomad Investment Partnership with effect from September 12th 2006, replacing Marathon Asset Management who had been investment advisor to the Partnership since inception. Prior to this transition Nicholas Sleep and Qais Zakaria were responsible for the investment management of Nomad whilst employed by Marathon Asset Management. Partners should note that the very nature of the transition from Marathon to Sleep, Zakaria and Company, Ltd., means that the Partnership does not benefit from the same back office infrastructure support it used to receive. In this letter we use the term "Partners" as a generic term referring to all Nomad investors, whether shareholders in the feeder fund (the Nomad Investment Company) or limited partners in the Partnership and not, in the strict, legal sense of the word, to imply the creation of a partnership between shareholders in the feeder fund, Nomad and/or Sleep, Zakaria and Company, Ltd.

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Nomad Investment Partnership

Interim Letter
For the period ended June 30th, 2007

To June 30th, 2007	Nomad Investment Partnership	MSCI World Index (net) US$
Trailing:		
One year*	+29.5%	+23.6%
Two years	+42.6	+33.8
Three years	+80.1	+59.0
Four years	+154.0	+97.2
Five years	+212.4	+92.5
Since inception (Sept 10th 2001)	+258.1	+81.9
Annualized since inception		
Before performance fees	+27.2	+11.9
After performance fees	+23.2	

The figures above are unaudited and presented on a cumulative basis. Below the same results are presented in discrete annual increments. In our opinion it is the upper table that is most useful in assessing long-term investment performance.

To June 30th 2007:	Nomad Investment Partnership	MSCI World Index (net) US$
Calendar Year Results:		
2007 (year to date)	+17.6%	+ 9.2%
2006	+13.6	+20.1
2005	+9.2	+9.5
2004	+22.1	+14.7
2003	+79.6	+33.1
2002	+1.3	-19.9
2001 (inception Sept 10th 2001)	+10.1	+3.6

Since the Partnership opened, and almost simultaneously closed, to new subscriptions (technically) at midnight on September 28th 2006 (blink and you missed it), the gross net asset value has risen over twenty-eight percent and means that a dollar invested in Nomad at inception would now be worth around $3.58. We usually quote performance after the cost of running the Partnership such as custodian, director, auditor and administrator fees, but before fees earned by the investment advisor. We quote results this way as many Partners** have different subscription dates and, due to the six percent performance hurdle used to calculate performance fees, will have various net-of-performance-fee experiences. The results above are also before our cost-reimbursement management fee, which does not make much of a dent to the net-of-all-fees result.

The circa forty percent annualized gain for Nomad since September last year is quite normal in the sense of being within an expected distribution of short-term results, but even so it is ahead of our averaged-out, multiyear return, which has been in the order of half as great. As ever, a stoic indifference to these short-term steps, both up and down, is the right way to think, and Zak and I would encourage you to mentally reallocate recent excess to leaner periods. Make that, future leaner periods! As Mrs. Zakaria and Mrs. Sleep remind us, we are no cleverer today than we were last year, although our results recently have been far superior.

The lag that often exists between investment decision and eventual reward is a problem for long-term investors, as the brain is wired to learn from immediate feedback. The biological presumption (and, as mentioned in the last Nomad letter, the academic presumption too) is that cause and effect sit chronologically on top of each other – after all, you would want to know that the plant you have just eaten is poisonous now (so you can stop eating it) rather than in a week's time, when it would be too late. Stock traders benefit from the same immediate feedback, but not so long term investors who run the investment equivalent risk of continuing to eat the hemlock. The real world is messy, and moves in a messy sort of way, and means that long term investors probably have to work harder at intellectual honesty so as not to mis-analyse cause and effect. We all fool ourselves to some extent and so this hair-shirted attitude is hard work. Perhaps it is the biggest investment challenge of them all!

An Introduction to the Santa Fe Institute

One way not to fool oneself is to spend time with one's intellectual superiors and it is in this spirit that Zak and I became members of the Santa Fe Institute (SFI) some years ago. The SFI was founded by Murray Gell-Mann and seven, principally Los Alamos, scientists who were frustrated with the gaps between contemporary academic disciplines. To this group, traditional academia discouraged broader interests (physicists study physics, not biology) and this left many problems unsolved because they fell across disciplines. Their solution was an interdisciplinary, collaborative approach to problem solving.

Witness the SFI's description of the economy. Traditional economists argue that people are rational beings who seek, what economists call, utility maximization, that is, the maximum output for any one input. This old guard are hostile to assertions of non-rational behavior, perhaps because the idea that we are all rational is just so elegant. Scientist and External SFI Professor W. Brian Arthur argues that this static, equilibrium based model of the world does not sit easily with the biologist's view that individuals act in self-interest, make mistakes, learn and evolve. Or the psychologists' view of the world that there are systematic biases to individual decisions – that is, we have these little wobbles in our decision-making processes. Brian Arthur's approach is to borrow what he needs from all the academic disciplines to describe a reality that is a little wayward compared to that the traditional economists would expect. As Gell-Mann puts it, the real world "is not just a look up table". Instead, Arthur describes the economy as a Complex Adaptive System that evolves as agents (people) learn.

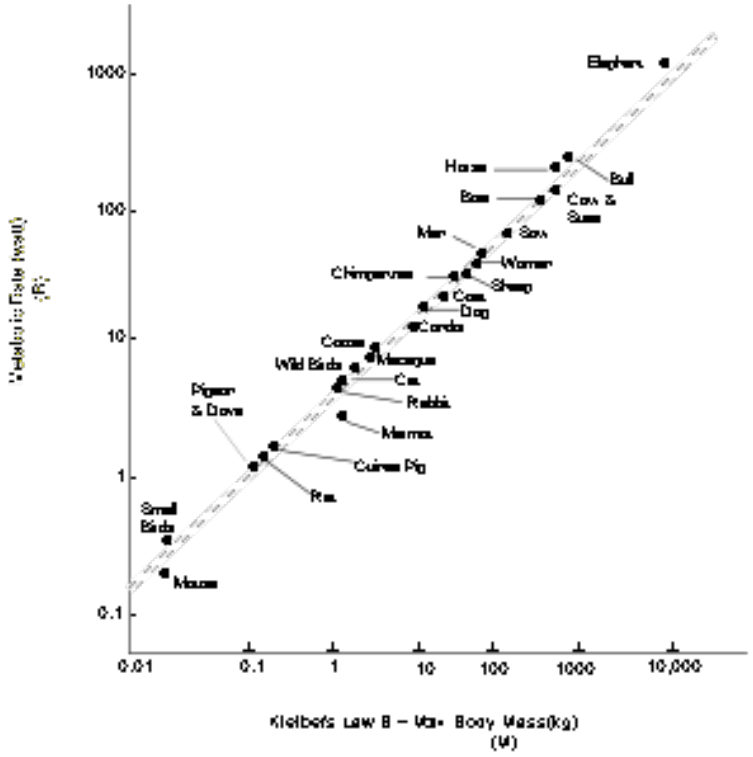
The SFI describes itself as studying the Science of Complexity and, in our opinion, that seems like a better model to explain reality. After all, how can economics not be behavioral – who is making the decisions after all? In our opinion, Brian Arthur's Complex Adaptive System and the behavioral finance work pursued by the likes of Professor Richard Zeckhauser at Harvard are the new economics in waiting. As the saying goes, one scientist would rather borrow another's toothbrush than his ideas, and it is with this attitude that, and with apologies to MBA students, the new economics of Complexity Science is unlikely to be taught to any great degree in academia until the utility maximizing old guard, that dominate academic institutions, die off.

After a recent speech Gell-Mann was asked, "So, how do you have creative thinking?" His answer was: 1. Start thinking about something, gather data to the point of saturation, recognise anomalies and recognise that you are now stuck; 2. Retreat and simmer, mull it over and a period of incubation ensues with the unconscious mind deployed; 3. Whilst doing something else a solution to the problem surfaces (Archimedes' eureka revelation); 4. Go and verify the new solution. To Gell-Mann, taking time is important in creative thinking. The landscape architect Charles Jencks, who designed the "Garden of Cosmic Speculation", echoes this sentiment. Jencks's garden is an attempt to put the new Science of Complexity into garden design and symbolism. (If in Dumfries, Scotland in June we thoroughly recommend a visit, and take us with you! – but note it is only open to the public for one day a year). To Jencks "understanding requires a certain slowing of time. Why else enter a garden?" There is a lot to be said for gentle contemplation. And of course, a long investment holding period allows one time between decisions to "retreat and simmer" a little.

An Introduction to Scaling Laws

It is perhaps only in a supportive, interdisciplinary institute such as the SFI that Geoff West could embark on a study of scaling laws. Two questions concerned West: why do small animals live for less time than bigger animals, and why do humans live for around one hundred years rather than say, one thousand years, or one year? The simplest of scaling laws concerns body-mass and skeletal strength. As an organism increases in size its body-mass grows with volume (to the cubed) whilst the shear strength of the skeleton only increases with the width of the bones (to the squared, or a power law of 3/2). Without a bigger bone structure, mass soon overwhelms strength, and the organism collapses under its own weight! (A few companies we know have followed a similar pattern). Metabolic rates (as measured by oxygen used) also rise with body mass, but at a declining rate (a power law of 3/4). This implies there is an economy of scale to mass in animals, further evidence of which might be that heartbeats per minute also decline with mass. This is Kleiber's Law and it states that literally a kilo of mouse costs more energy to live than a kilo of say, whale. West put the two power laws together and realized that if longevity increases with mass, and the heart rate decreases with mass, then it follows that all life shares a common number of heartbeats (indeed, around one billion). A mouse uses up its billion heartbeats in about four years (at a rate of five hundred beats per minute) whilst an elephant uses up its billion heartbeats in seventy years (at a rate of twenty-five beats per minute). It seems that evolution has not changed this basic constraint: a billion heartbeats it is, careful how you use them!

Chart1: A billion heartbeats it is: careful how you use them!



Source: Santa Fe Institute

But even so, why does the mouse heart beat so quickly? In all animals the aggregate cross sectional area of the blood vessels increases with distance from the heart. The purpose of this is to overcome the viscous drag created by blood coming into contact with vessel walls. Smaller animals do not have the space in their body to allow for much cross sectional widening, and so the mouse heart works harder to overcome the blood's resistance to flow. In larger animals the distance between the heart and the body's cells is much greater and so the cross sectional area can be increased much more.

In other words there is a very basic function to longevity with skeletal strength allowing for size, size allowing for circulatory efficiency, and efficiency allowing for longevity. The answer to West's question is that man lives for around a hundred years as this is all his heart can cope with, given body-mass and skeletal strength.

What can Investors learn from Scaling Laws?

This might be the right way to think about scaling in organisms, but does it tell us anything about companies, and especially firms as they grow? The question that needs to be answered is: why is it predictable that a business will grow from a mouse to an elephant? This is a little like asking the meaning of life, and we will try hard not to give an answer as intractable as Douglas Adams' suggestion in The Hitch-Hiker's Guide to the Galaxy (where the answer to life, the universe and everything was "42"!). Several tenets are important. A business ought to be able to self-fund its own growth, and if the opportunity set is large, then the return on capital needs to be suitably high. Second, barriers to entry should increase with size; that way a company's moat is widened as the firm grows. To do this, the basic building block of the business, its skeletal structure, is probably best kept very simple. In short, we want a skeletal structure that can support growth from mouse to elephant without too much skeletal re-engineering.

Let's consider traditional high street retailing. Goods are sent from the supplier to the retailers' central warehouse, where they are stored until demanded by the shops. Goods are then sent to the high street stores. These are expensive pieces of real estate, and have high operating costs. Price aside for a moment, the quality of service the consumer perceives is largely a function of staff levels, staff helpfulness, product range, shop furnishings and so on. So there are lots of constantly variable elements to service quality at the most expensive end of the distribution system. It seems to us that the skeletal structure is highly complex, and many things can go wrong.

Contrast this to the internet model. Goods are sent from the supplier to a central warehouse, but often only after the order has been taken. The goods are then sent direct to the customer with the expensive high street real estate missed out. The quality of service perceived by the customer is the speed of delivery, the feel of the web site, functionality of the web site (such as recommendations), breadth of product range and so on and these factors are inherently more controllable. They are fixed in terms of expense and also customer experience (a web site viewed in New York looks the same as the same website viewed in London or Hong Kong). So whilst quality is inherently patchy at most high street retailers, it is fixed at Amazon. This is important as it is complexity that is one of the main reasons firms fail as they try to grow.

It seems to us that the basic building block of internet retailing, its skeletal structure, is far more robust, scalable and cheaper than the high street equivalent. In other words its power law is very high, and implies that businesses with the simplicity of operation as say, Amazon.com, have a shot at being far bigger, quicker and more profitable than their high street equivalents. Nomad has an investment in Amazon for more reasons than the firm's simplicity of operations. But when this basic building block is combined with the scale efficiencies shared model (which increases the moat as the firm grows), customer centric orientation of the firm's founder, as well as his healthy disdain for Wall Street, this combination makes us think that we may have a mouse that can turn into an elephant. To those who argue Amazon is large already we ask two questions: what do you think e-commerce will be as a proportion of US retailing in ten years time, and what do you think it was last year? Write both numbers down and turn to the end of this letter*** for the answer to the second question.

After the doubling in the share price and the weighty resultant position in the Partnership it would be easy for Zak and me to claim victory, high five, and sell our shares in Amazon. However, the high weighting makes sense given our understanding of the destination of the businesses and the probability of reaching that destination. In previous Nomad letters we have argued that the biggest error an investor can make is the sale of a Wal-Mart or a Microsoft in the early stages of the company's growth. Mathematically this error is far greater than the equivalent sum invested in a firm that goes bankrupt. The industry tends to gloss over this fact, perhaps because opportunity costs go unrecorded in performance records. For example, our greatest error was the sale of Stagecoach (which has risen ever since sold), not the purchase of Conseco! We wonder, would selling Amazon today would be the equivalent mistake of selling Wal-Mart in 1980 (a similar time period after both companies' IPOs)?

Short-term result volatility and stock weighting

It is common-place for overall portfolio construction to be as a result of stock weightings built up from one to two to three percent of a portfolio and so on up to a target holding. This means that weightings are anchored at a small number with only outliers reaching double digits. There is another way to construct a portfolio, which is to invert and start at a hundred percent weighting and work down! If fund managers did this, I am sure they would end up with completely different portfolios. Now we are not advocating all the fund in Amazon (well, not just yet at least), but in allowing past habits to anchor portfolio construction we have probably made the mistake of a starting holding that was almost certainly too low. Be that as it may, one effect of having one sixth of the Partnership invested in a volatile stock, such as Amazon, is that our results will also be more variable over the short term. Please bear that in mind in future performance. The volatility does not bother Zak and me one jot.

Our results since inception have been large, out-sized multi-year gains during periods of market distress (2001 to 2004) and reasonable, index matching/bettering multi-year results during stock market boom periods (2005 to 2007). This follows the predicted path outlined in the June 2002 Nomad letter when we quoted a Buffett Partnership letter from 1960:

"I have pointed out that any superior record which we might accomplish should not be expected to be evidenced by a relatively constant advantage in performance

compared to the Average. Rather it is likely that if such an advantage is achieved, it will be through better-than-average performance in stable or declining markets and average, or perhaps even poorer-than-average performance in rising markets."

And we certainly do not have a relatively constant advantage compared to the index!

The Deep Reality of the Markets.

It was recently reported that oil had been found, not in the far flung reaches of the globe, but under the headquarters of the Exxon Mobil Corporation in Irving, Texas, and not by Exxon! Sometimes, what you are looking for is right in front of you. If Exxon can make this mistake, we all can. Investors are often guilty of chasing the new-new thing far from home sometimes in the name of diversification, or higher returns, or both. To our way of thinking such activity often has more to do with marketing than it does with underlying investment reality. Selling the new thing in order to buy the new-new thing is a common human habit (as a society we trade houses, cars, wives rather than try to fix roofs, gearboxes, marriages) and it almost always raises the question, why are people dissatisfied with what they have? In the spirit of trying not to make Exxon's mistake, we suspect that Nomad portfolio turnover will be particularly low going forward: we are quite happy with what we are currently sitting on. One reason for this is that the fund is over-whelmingly (over eighty-five percent) invested in firms run by their founders or first generation management. Just as interesting is that Zak and I did not plan for this! We have ended up with a portfolio of owner-managed businesses as a by-product of our assessment of the quality of the people involved. In other words, these managers earned their way into the portfolio. We feel slightly foolish for not recognizing this trait in advance, but, of course, we *would* have a bias toward founder-managed businesses (duh!).

By the standards of the industry we do not own very many shares (ten stocks account for over eighty percent of the Partnership) and we own them for long periods. If the existing portfolio is to be successful then our results will come from the mismatch between the orientation of the founders and the mark to market mentality of the quarterly holding period investors that set the price of the companies on the stock market. This principal (founder) agent (trading oriented fund manager) conflict is the deep reality of the markets and probably the dominant characteristic of our careers. I also think we understand it far better than our peers.

The Terms of Future Capital Raising.

Before there is any sucking of teeth, we do not have any plans to raise capital. Really. But we do wish to set out our stall now for the next investment crisis, and that crisis could come quickly. As we have always said in the past, capital should only be raised in response to investment opportunity sets (to be slipped into the suggestion box of marketing oriented fund management operations). Rightly or wrongly (and there is a perfectly rational case that we are wrong) we have an over-riding bias to keep our operation small. However, we are also conscious that a repeat of the Asian crisis or the junk bond crisis would allow us to invest multiples the current size of Nomad with better results for all concerned. So, for illustration, lets say Nomad is a U$1bn Partnership and there is a new crisis and we raise a further U$1bn with the result that after the crisis has abated, Nomad is say, U$4bn in value. U$4bn is not a small

amount of capital, especially in a concentrated portfolio. The rational thing may be to return the crisis capital to investors and right size back to the original capital. So, our suggestion is that a future capital raising would, in effect, be a rights issue of redeemable shares, which would give Zak and me the option of shrinking. We are flagging this now, and we welcome your thoughts on the subject. Speak up or forever hold your peace!

Housekeeping

We write these letters and hope to provide all the useful-to-know information to allow you to draw meaningful conclusions about our ability to manage your money. This is the information we would want if the tables were turned, and you managed our money. In our opinion, more regular reporting of a long-term fund is meaningless at best, and counter-productive at worst. It is only in the Alice-in-Wonderland world of the modern investment profession that incessant gathering of puerile data points can pass for best practice reporting. There's that principal agent conflict again! It is to the very great credit of our Partners who, almost to a man and regardless of demands made of other managers, abide by this simple rule. Thank you.

We have excluded a copy of the portfolio from the appendix, and instead it will follow under separate post, or email. This is a precaution against our letter being circulated beyond our investor base. Included in the appendix you will find a copy of our response to a Partner's request that we consider divesting of businesses with operations in the Sudan. The letter makes our position on the issue clear, and there is little point in repeating the words here. Sudan is not so much the point, as previous requests have been made relating to arms, tobacco, alcohol, or certain South African and Irish businesses. The wider issue is the governance of our Partnership, and whether a minority group should be allowed to assert an agenda over the majority. For better or worse, the Partnership structure means that Nomad is a cooperative (of sorts), albeit with a mandate for the long-term growth of capital. In our analysis of investments, we may well take into account the factors raised by those that seek a ban on certain companies but, so all is clear, we may still buy the shares. Of course, how investors then allocate any profits they may have from their investment in Nomad is entirely up to them.

It is nine months now since Nomad was handed to the new company and operations appear to be bedding down well. We are gently reviewing the old, inherited relationships and contracts and there may be some changes to subcontracted parties to come. It is interesting how attitudes change now that Nomad is no longer part of a large organization. These changes are very often for the better, but occasionally those firms with a cookie-cutter business model struggle with our more bespoke approach and they need to be swapped out. The cost-reimbursement management fee is settling down in the low 30 basis points. This is at the high end of our (back of the envelope, not done this before) expectations, and we expect it now to stay flat in dollars and decline as a proportion of the Partnership in time.

Performance has been strong since we raised new capital (we weren't making it up!), but Partners should not extrapolate recent trends in their expectations of us. That is simply a recipe for everyone to get upset. That said, the portfolio is young and fresh and is populated with businesses that are healthily out of step with Wall Street or City

expectations. Instead our founders are planning for growth in five years time. This "founder's portfolio" will serve us well in the absence of investment crises.

In my first week as a trainee investment analyst (having just abandoned a landscape architecture apprentiship) one of the founders and fund managers of my new employer sat me down for some homely advice. In his broad Scottish accent he said, "well, young Nick", there was then a long pause and he began to smile "this job is the best fun you can have with your clothes on". He was right. Zak and I love running Nomad, and to do so under our own steam is special to us. Thank you.

We prize your patience, support and confidence in us, and we are working hard preparing the ground for further increases in the Nomad share price.

Yours sincerely,

Nicholas Sleep

* Sleep, Zakaria and Company was appointed as investment advisor to the Nomad Investment Partnership with effect from September 12th 2006, replacing Marathon Asset Management who had been investment advisor to the Partnership since inception. Prior to September, Nicholas Sleep and Qais Zakaria were responsible for the investment management of Nomad whilst employed by Marathon Asset Management. Partners should note that the very nature of the transition from Marathon to Sleep, Zakaria and Company means that Zak and I are not operating with the back office infrastructure we used to receive.

** In this letter we use the term "Partners" as a generic term referring to all Nomad investors, whether shareholders in the feeder fund (the Nomad Investment Company) or limited partners in the Partnership and not, in the strict, legal sense of the word, to imply the creation of a partnership between shareholders in the feeder fund, Nomad and/or Sleep, Zakaria and Company, Ltd.

*** The US Census Bureau estimates that e-commerce sales grew from 2.7% to 3.1% of all retail sales in the United States during the quarters of 2006. The source document can be found at www.census.gov/mrts/www/data/html/07Q1table1.html.

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Appendix:

Dear

Thank you for your letter informing us of your concerns with conditions in the Sudan and linking this to any investments Nomad may have. Zak and I agree that conditions in Darfur are appalling and we sympathise with the desire to do something about it.

As Nomad has no investments among the list of companies provided, it would be easy for us to just leave it at that. (Phew!) However, the logic of the proposition raised an eyebrow or two here, and there are some interesting principles at foot, so may I elaborate?

We do not necessarily divest our shares in companies because we disagree with a particular activity of that company. Heaven forbid – there would be nothing left to invest in! I am sure that as I write this someone, somewhere in an investee business is doing something Zak and I would very much regret, and we live with that reality.

Even if we did choose to take exception to a company's activity, would divesting our shares work? In our experience being inside a company is far more likely to influence behaviour than being outside. After all, shares come with votes! Indeed, if all those that agreed with the proposal sold their shares to those that disagreed, would that not risk entrenching the activities of the company? It seems to us that an open debate both inside and outside a firm has a greater hope of influence than a scenario where management can hide in the boardroom protected by their shareholders' support.

Nomad is a pooled fund (not a bespoke, segregated fund) and, if we did divest an otherwise sound investment, perhaps at a price depressed by others pursuing the proposed strategy, we may be rightly criticised by other Nomad investors for placing the proposer's interests above their own. That is not a conversation I would relish! Let's invert the situation: how would the proposer feel if another investor in Nomad proposed to divest a series of companies on the grounds of an issue they did not feel strongly about?

I am sure some investors in Nomad have different views to our own on, say, tobacco, alcohol and arms (all permissible) and we all get along quite well under the general mandate to grow capital over the long term. Of course, how investors then choose to spend their profits from investing in Nomad is up to them.

Whilst the motivation is understandable, the consequences of the proposal, and the consequences of the consequences (the "what thens" of the situation) may not be what was wished for.

So to be clear, Zak and I disagree with the rational logic of the proposal, and we would consider making an investment in, say, Rolls Royce, if we came in tomorrow and the share price was £1.

Indeed, we should all be so lucky!

With all best wishes

Yours sincerely

Nicholas Sleep

Nomad Investment Partnership

Annual Letter
For the period ended December 31st, 2006

To December 31st, 2006	Nomad Investment Partnership	MSCI World Index (net) US$
One year*	+13.6%	+20.1%
Two years	+24.1	+31.5
Three years	+51.3	+51.5
Four years	+171.8	+103.0
Five years	+175.3	+63.8
Since inception (Sept 10th 2001)	+203.2	+70.2
Annualized since inception		
Before performance fees	+23.2%	+10.6%
After performance fees	+20.4	

The figures above are unaudited and presented on a cumulative basis (after management fees, the cost of running the Partnership including custodian, auditor and administrator fees, but before performance fees). Below the same results are presented in discrete annual increments. In our opinion it is the upper table that is most useful in assessing long-term investment performance.

To December 31st, 2006:	Nomad Investment Partnership	MSCI World Index (net) US$
2006	+13.6%	+20.1%
2005	+9.2	+9.5
2004	+22.0	+15.2
2003	+79.6	+34.0
2002	+1.3	-19.3
2001 (inception Sept 10th 2001)	+10.1	+3.9

The Benchmark

2006 was quite a year for Zak and I in all respects bar one: Nomad was successfully separated from its alma mater, the new refundable performance fee and cost reimbursement management fees were (perhaps unsurprisingly!) accepted by Partners**, and we seem, broadly, to have all the systems we need to operate an effective investment function established in Galactic headquarters at Burnsall Street. Even so performance, certainly relative to one alternative presented by the index described above, was only so-so. Alright in absolute terms, and reasonable perhaps as we compound our way along but, I'm afraid, in 2006 you would have done better buying an index fund (if only we knew which to buy in advance?)

So there is no confusion: the index is not our benchmark. Zak and I spend no time at all thinking about the index (indeed we were unaware of the index return until I set about writing this letter) and its inclusion at the top of this letter reflects our genesis in an index-relative investment firm more than our orientation. If we started Nomad again today, I'm not sure we would present results this way but, be that as it may, we will leave the index at the top of this letter for now, as for some Partners it may be helpful in placing our results in context.

Zak and I have witnessed many investors make terrible investment decisions from thinking via the index. The most common mistake is to view the index (indeed any index?) as a risk-free "home". That this disposition still exists after the irrational index bubbles that preceded the Asian crisis and technology collapse may be testament to the strength of the marketing skills of the financial establishment. Once the index is seen as risk free the mistakes that follow cascade and include: requirement to have an opinion on everything inside the index regardless of one's circle of competence, an unwillingness to invest in other better opportunities, and over diversification. These three mistakes destroy a lot of capital. We came across one country manager's report claiming that although his country had done poorly it had proved valuable as a "portfolio diversifier" in a global fund: Many a furrowed brow these last few weeks figuring out what that means! Even so, index relative funds are the industry norm because they sell. And they sell because the client does not trust their manager with the keys to the Ferrari. It is a ghastly Faustian pact.

We are walking down the road less traveled when we argue that the index is not risk free, it is one, of many, opportunity sets. This year that opportunity set beat us. It may do so again next year too. And the year after that. We should all be prepared for that possibility and stoic at its occurrence. A rational mind understands that it is the

destination that is important, and if we have some skill in picking stocks (please, no answers on a post card!) then, whilst annual returns may bounce around, our destination will be some way ahead of the index. Zak and I are not envious of index returns and we encourage you not to be either. We see our goal as far more personal than that. Our goal is a track record to be proud of, we wish to accomplish something meaningful, and to do that we aim to earn returns, over time, on par with those investors we greatly admire (Ruane, Tweedy, Klarman, Whitman, Hawkins, Miller, Schloss, Berkowitz). In no way do we guarantee returns, but if we can approach their results then, over time, we will beat the index too.

The fifth anniversary of the inception of Nomad occurred in September 2006, and represents a suitable milestone from which to assess the journey so far. A few weeks after the anniversary the share price rose through U$3000 (before performance fees) and this means that it took a little over five years to triple the original dollar invested. (We usually quote performance before performance fees. We do this as many Partners have different subscription dates and, due to the 6% performance hurdle used to calculate fees, will therefore have various net-of-performance-fee experiences. The net-of-performance-fee share price was U$2680 at year-end). 23% per cent compound per annum for five years in a 5% interest rate world is perhaps ahead of what we might consider normal performance and, as we have said in the past, reflects the opportunity set in the early days.

There are two reasons for our relative performance this year – the first is that our companies, by and large, are reinvesting heavily in their businesses at a time when the market, taking its cue from the private equity buyers, have rewarded firms with high levels of current free cash flow. Second, it is also possible that the one off workload associated with the transition of Nomad to SZ and Co, a very high proportion of which was bespoke work (notably the refundable performance fee), diverted attention from the day job. Zak and I consider non-investment distractions to be the single biggest risk to our operation and we are on to it. Amanda has the budget she needs to allow us to devolve duties but this process is new to us and we are learning as we go.

In 1948, Freddie Settrington (he rarely used the title Lord March) hosted his first motor racing event on the perimeter road of the airfield that lay in one corner of his Sussex estate. At first it was a modest affair, as the foreword to the first race card makes clear:

"We'll be quite frank with you from the start. This race meeting is an experiment. We cannot, on this occasion, offer you a seat in a grandstand – or even a seat at all. You'll be able to obtain some refreshments, and the loudspeaker people will do their best to make certain you hear the numbers of non-starters and of the winners.

"We think you will see some quite good racing, and share our surprise if the programme keeps up to time. But if all the refinements of a fully-developed sporting arena are missing take our word for it, they will appear eventually- particularly if we have any success with the show today.

"Meanwhile, months of negotiations have been necessary, just to make to-day's meeting possible. Government Departments have been involved – and you know

what that means – but we've stuck manfully to the job, and here we are. To do justice to those with whom we have been called upon to negotiate, we must say that Government people have been more than helpful. Ministry of Works officials wear collars and ties, drink and eat just like you or I, and smoke cigarettes at 3s.6d. a packet. Sometimes, though, they do a little better with petrol.

"We've been greatly assisted, too, by local farmers, who do not subscribe to the view that dairy cows refuse to come across with the milk if they are within earshot of a racing car.

"Naturally, in the J.C.C. we are more than pleased to be staging our first race meeting in England since the war. As someone said the other day, we are a little lucky in having a President with an airfield in his back garden, but it's better to be born lucky than have to pay 19s. 6d. in the £."

Today, the Goodwood Revival is a unique, world-class motor racing event. In the last year we have also spent our fair share of time with the bureaucrats and, like Freddie, at times we would have struggled to offer you a seat (the office fit-out rumbles on). But, in time, we aim to produce something we can all be proud of and, we expect, that at Nomad you will also see some quite good racing.

An Overview of the Partnership.

Good investing is a minority sport, which means that in order to earn returns better than everyone else we need to be doing things different to the crowd. And one of the things the crowd is not, is patient. Readers of our letters (there must be some) may be familiar with the notion of the equity yield curve, and our thoughts were covered in an interview for the Outstanding Investor Digest (reprints available upon request, do ask Amanda) a few years ago. (In brief, the equity yield curve is a concept that argues that patience has a value, and that returns increase with time in the equity market as they do on a normal bond market yield curve). In the bond market the higher yield is there to compensate for the increase in risk that the principal will not be repaid, or that the principal may be devalued by inflation. That is not how it works in the equity market: in our opinion business outcomes can be more predictable several years out than they are in the near term. For example we have no idea where the market will end this year but, given corporate strategies, capital allocation and starting valuations, I think we have some idea of how our companies will evolve over the next few years. In other words (at this point economics students may wish to cover their ears) the return from investing in shares can be both increased and de-risked by time.

There may be a blind spot in academia as the overwhelming methodology for research in Economics has been to take observations over short time periods, as if cause and effect sit on top of each other. Habits can take years to form. What, we wonder, would academics have to say of Coke's century long advertising program and the eventual establishment of the World's most valuable brand?

It is interesting to us that Nomad's performance by vintage bears evidence of the equity yield curve. Take the current portfolio: stocks held for over four years have superior *annualized* returns compared to those held for between three and four years, which have higher *annualized* returns compared to those held for two to three years

and so on down to stocks purchased last year, which are a pretty mixed affair and contain several losses! The numbers are skewed by survivorship bias (no Conseco) but exclude stocks sold that have continued to do well (notably Stagecoach, which has risen ever since we sold it!). There is opportunity set bias in these numbers too ('02 may be a better year for making new investments than '06) but even so, the steepness of the curve (over 1000 basis points per annum) is cause for optimism, as it implies patience is rewarded. It is with some interest that, on average and weighted by size of holding, the investments in the Partnership today are just over one year old. In other words Nomad is a young portfolio, perhaps one fifth of the way through its normal life expectancy. The competition is so great that we have little advantage at the short end of the equity yield curve – after all the average holding period of US mutual funds is less than one year – and so one might expect current returns to be so-so. However, if the past is our guide and as the portfolio matures, its best years may yet lie ahead.

How do we know we are taking a different view to the crowd? A clue can be gleaned from the period that other investors typically hold the shares of the companies in the Partnership. If Berkshire Hathaway (US), Jardine Matheson (Hong Kong) and Next Media (also Hong Kong) are excluded (these firms are in a class of their own due to either stock illiquidity or investor education) then other investors hold stocks in our portfolio for on average twenty weeks. We expect to own shares for around two hundred and sixty weeks! So, what is going on? It seems to us that most investors look at the accounting outputs of a company (the reported financial data) as a guide to near term price movements and play the market accordingly. As stated in the investment objective section of the Nomad prospectus our goal is to "*pass custody* (of your investment) *over at the right price and to the right people*". That's what investing is. Zak and I concentrate on a deeper reality: the inputs to future value moves. Our peers are trading shares at the short end of the equity yield curve where the competition is the greatest, and we are investing at the long end where competition is the least. We respond to completely different stimuli.

Take for example the current controversy at Amazon.com. Last year the company reported free cash flow of just over U$500m, indeed it has been around this number for the last few years. What is important is that the U$500m is after all investment spending on growth initiatives such as capital spending, but also research and development, shipping subsidy, marketing and advertising and price givebacks. The firm has been investing in these items today to grow the business in the future so that free cash flow in years to come will be meaningfully greater than it would be otherwise. By our estimates these discretionary investments, over and above that required to maintain the business, are in the region of a further U$500m, excluding the price givebacks. This is our subjective assessment of the discretionary investment spend and implies that management could, if so inclined, cancel the discretionary growth spending and instead return around U$800m per annum to investors after taxes. An operation that was able to produce cash flow on such a basis might be worth U$10bn or so, and along with Amazon's other assets would imply a share price of around U$26. In valuing the business at these prices, as occurred last summer, investors are saying to Amazon management "your growth spending has no value, you may as well turn yourself into a cash cow"! This is an odd statement to make for a business growing revenues in excess of twenty percent per annum.

How should we think about the price givebacks? Here is what Jeff Bezos, Amazon's founder, had to say in last year's annual report:

"As our shareholders know, we have made a decision to continuously and significantly lower prices for customers year after year as our efficiency and scale make it possible. This is an example of a very important decision that cannot be made in a math-based way. In fact, when we lower prices, we go against the math that we can do, which always says that the smart move is to raise prices. We have significant data related to price elasticity. With fair accuracy, we can predict that a price reduction of a certain percentage will result in an increase in units sold of a certain percentage. With rare exceptions, the volume increase in the short-term is never enough to pay for the price decease. However, our quantitative understanding of elasticity is short-term. We can estimate what a price reduction will do this week and this quarter. But we cannot numerically estimate the effect that consistently lowering prices will have on our business over five years or ten years. Our judgment is that relentlessly returning efficiency improvements and scale economies to customers in the form of lower prices creates a virtuous cycle that leads over the long-term to a much larger dollar amount of free cash flow, and thereby to a much more valuable Amazon.com. We have made similar judgments around Free Super Saver Shipping and Amazon Prime, both of which are expensive in the short term and – we believe – important and valuable in the long term."

This is a précis of the scale efficiencies shared model that we dealt with in some detail in our analysis of Costco (Nomad Letter to Investors, December 2004, please ask Amanda for reprints) and is deployed by companies which have now come to dominate Nomad: Costco, Dell, Amazon and Berkshire (Geico, Nebraska Furniture Mart). The controversy is in the first four words "*As our shareholders know*", judging by the share volumes - they don't! And that's the opportunity. If the share price is being set by those with an eye on the next data point, then they can't also be looking out for long-term value. There are few traders that disagree with Bezos' value creation process, but they don't think it will show up in the numbers just yet. And if you only own shares for a month or two then you may get away with several trades before Amazon's success becomes apparent. In short, the traders have many small ideas, and we have one big idea. Good luck to them. Picking up pennies in front of a juggernaut is just not how we behave.

Notice also that the decision to lower free cash flow this year through sharing scale benefits with customers through price givebacks is based on a subjective judgment of future returns and their timing. It is not a strictly maths based equation and there is no guarantee that investment spending will always work. Bezos again:

"*Math-based decisions command wide agreement, whereas judgment-based decisions are rightly debated and often controversial, at least until put into practice and demonstrated. Any institution unwilling to endure controversy must limit itself to decisions of the first type. In our view, doing so would not only limit controversy – it would also significantly limit innovation and long-term value creation*". Amen.

I think Bezos would run a good investment fund: but that is the point, good investing and good business decisions are synonymous. Mr. Bezos does not control the timing of the payback, just as we do not control the timing of Nomad's performance but, in

our judgment, the ever widening of the moat surrounding Amazon largely determines whether our investment will be a success. We must now have the patience to wait.

Today Nomad is close to fully invested and notably concentrated: the five largest holdings account for half the portfolio and the top ten around three quarters. The tail of around twenty other holdings includes baskets (such as Zimbabwe), several distressed turnarounds and rats and mice from the early days. The polarity of the portfolio, with several large, simple, high conviction holdings, and a tail of more complicated and less certain ideas (but which may have more upside) is likely to be a feature of Nomad for some time. There is a notable concentration in US stocks, a factor that also contributed to relative performance last year, while there are some interesting UK investments where we may have some influence on corporate development. The price to value ratio of the Partnership as a whole is in the upper 60 cents on the dollar, having risen from the low 60s in October.

Why do Problems go Unsolved? Because they Fall Across Disciplines.

Whilst Zak and I are delighted at the doubling of the value of Nomad shares between 2001 and 2004, this would be for nothing if returns had been given back in the last two years. As it is we have been able to reinvest the portfolio in new opportunities and the fund has continued its rise. There are several funds that, over the last few years, have created a similar track record to ours by investing in specific countries (Russia, India, Egypt etc) or sectors (gold, oil, basic materials). Investors with holdings in the fields listed above should be aware that more narrowly focused funds will find it hard to maintain their performance if the bull market in their fields starts to fail.

What we are saying is that because so many fund managers are constrained by their mandates excess returns ought to exist for the unconstrained. The turn-of-the-millennia technology fund manager could not invest in Stagecoach (a bus operator) even if he had wanted to. For this reason it seems to us that there is more to the private equity boom than just low interest rates. In a world where traditional fund management is compartmentalised by attributes such as geography, sectors, investment styles (value, growth, garp, momentum), tracking errors, beta, listed or unlisted status, (stay awake at the back) equity or debt, bankruptcy or solvency then those with broader powers, such as private equity, and indeed Nomad, should have an advantage over constrained incumbents. Woody Allen once quipped that being bi-sexual doubled the chances of a date on Saturday night, curiously that principle also applies to investing.

Rules based systems always contribute to societal non-thinking, but it's not the mandates so much that are the source of risk to investors in constrained funds. It's the attitude of the non-thinkers running the funds that is so destructive. The following excerpt taken from the December 2003 Nomad Letter to Shareholders summarizes our views:

"*The Weetabix offer is only one of many privatisations of cheap, small and mid capitalisation businesses in the UK. Institutional shareholders have abandoned these firms in favor of mega-caps, and the shareholder base is left dominated by one or two inside interests and a tail of small holders. Our view is that the discount that the shares trade at in the market is an asset to be harvested for the benefit of all*

shareholders through share repurchase. But human nature being as it is, insiders will be incented by the low valuation to buy the shares for themselves. A Scheme of Arrangement is the most ruthless method of asserting one party's will over a fragmented and non-professional shareholder base, and coupled with irrevocable acceptances allows takeover offers to be presented as a fait accompli to shareholders. Please note: bad practice spreads. Despite this, and the almost daily occurrence of privatization proposals in the UK, there has been almost no criticism by shareholders, the authorities or in the media. In no other sphere of capitalism can your property be seized in exchange for cents on the dollar (except compulsory purchase on the grounds of national interest). But fund managers, who in their private capacity would be insulted if someone offered less than their house was worth, happily sell shares in their professional capacity at discounted prices to smart buyers. And no one cries foul."

The fund managers understand what is going on. These are intelligent, highly paid individuals who could defend their clients' interests much more vigorously. They could, for example, own much more of the target company and block the bid. Or, if mandate constrained to only invest in listed equity, why not explain the situation to their clients and seek to change the rules of their funds to allow ownership of, say, unlisted equity? But not a squeak. Many fund managers would rather sell your shares for a small takeover premium now (and market their short term performance to new investors) whilst turning a blind eye to the doubling in the value of the sold business over the next few years. It's a scandal.

The December 2003 letter again,

"Whilst we have a profit on our investment in Weetabix, shareholders should be careful what they wish for. Before congratulations are in order, Partners need to weigh in their minds short-term profits against value forgone in the discounted offer price and the incentive provided by the success of seizure for potentially more of the same in the future."

Just look at what is happening in the markets now: 2006 was a record year for private equity funds. As the bids often come from the private equity fund operating in joint venture with management then, in our opinion, they are best understood as insider trading with the takeover rules being used as a bulk purchasing facility. In the UK (and some former colonies) there is some protection against corporate wallet lifting as dissenters (those wishing not to sell) cannot be compulsory acquired if they own more than 10% of a company. The situation is far worse in many other countries – for example in the United States there is no universal protection against compulsory purchase! Back to the December '03 letter:

"So what is to be done? The best defense is to own enough of the company to influence the outcome. In most cases [in the UK] *in excess of 10% of the shares outstanding would suffice. Those that advocate market liquidity of their investments over other considerations might like to bear in mind an investor's inability to influence outcomes whilst owning a deminimus proportion of a company. Should Nomad continue to grow in size, we intend not to make this mistake."*

To this end Nomad is now the largest shareholder in Games Workshop Plc., a significant shareholder in Jarvis Plc., and part of the dissenting group at Whitehead Mann Plc.

Whitehead Mann has a reasonably entrenched position as the largest headhunter to FTSE 100 CEOs and used this cyclical revenue stream to fund the acquisition of several competitors (often with insiders cashing out!). As revenues declined the interest burden overwhelmed failing cash flow and the share price declined from a peak of £4 to around 50p when we first went to meet management two years ago. At the time the firm was seeking more capital in the form of a bankruptcy avoiding rights issue and placing. It seemed odd to us that the insiders were not buying shares in the firm along with their shareholders and so we declined to participate, "we'll be bullish when you are bullish" we told the MD. Even so, capital was raised at 40p per share from other investors and we sat and watched from the sidelines. Then last year the company announced that management, along with a private equity fund, were offering 42p to buy the whole company and had secured irrevocable undertakings from shareholders to purchase around seventy percent of the shares outstanding. In other words, having saved the company investors were being offered a return of 2p (five percent) for their trouble! And insiders, who had chosen not to invest in the bankruptcy-avoiding placing, now wished to buy as much as they could (via the bulk purchasing facility) and so we also made an investment. Today we are part of a dissenting shareholder group that own around 19% of the shares, enough not to be compulsory acquired. As we will continue to own our unlisted shares we propose, in the absence of more information, that the shares be valued in Nomad at the takeover price (42p) plus (or minus) retained earnings. We look forward to seeing what management can do for us now they have (leveraged) skin in the game.

Some Housekeeping

Contained in the appendix of this letter is a copy of the schedule of investments at year-end (please hide under your mattress) and the two letters we sent to Partners last year, one that outlines the philosophy of our operation and the second the methodology of the performance and management fees. These are important letters, and are reprinted here for your reference.

Your first port of call with enquiries as to performance and valuations should go to Gavin Gray and his team at Phoenix Financial Services in Dublin, Ireland. They can be reached at +353 1 845 8161, do call them! Gavin was one of the few administrators prepared to rise to the challenge of our non-standard cost-reimbursement management fee and redeemable performance fee. Whilst other administrators wished to shoe horn Nomad into an existing cookie cutter, for the same money Phoenix will administrate our bespoke arrangement. Over time that will prove to be a considerable saving in fees paid by Partners. We have found Gavin and his team to be intelligent and helpful and we are glad to have them along. Amanda Joss (+44 20 7101 1960 and amanda@sleepzakaria.co.uk) can help with literature, reprints and diaries, and directions to the office can be found on our, somewhat homespun, web site (www.sleepzakaria.co.uk). On viewing our web site some friends, perhaps with higher technical aspirations than ourselves, asked: "is that what you want?" It is! We will leave the web-pyrotechnics to Amazon.

We write these letters and hope to provide you all the useful-to-know information about Nomad and us. This is the information we would want to know if we were in your position. We shy away from more frequent reporting which risks say-something syndrome and at worst may provide a meaningless comfort blanket. Any psychological security you receive from us should be a product of our attempts to be more rational than the crowd.

The portfolio feels fresh and young, and is healthily out of step with consensus. Many holdings are companies of real character and product integrity, in contrast to stocks held a few years ago. New ideas are coming into the hopper at a good rate and Zak and I are unrestrained to think and research in a way that has not been possible for some time. We are acutely aware that whilst our record may be the tripling in the share price (before performance fees), one in seven Partners and around seventy percent of the dollars invested in Nomad are new since September 30th 2006. Nomad is up around ten percent since then and, in the scheme of what we do, that is hardly worth the comment. It seems healthy to us to see the clock as substantially reset by the increase in funds under management, and in no way are we resting on our rolling performance numbers. In many respects it is day one all over again.

As ever, it is an absolute pleasure running the Partnership. We thank you for the opportunity to do so under our own steam and for your patience and confidence in us,

Yours sincerely,

Nicholas Sleep

* Sleep, Zakaria and Company was appointed as investment advisor to the Nomad Investment Partnership with effect from September 12th 2006, replacing Marathon Asset Management who had been investment advisor to the Partnership since inception. Prior to September Nicholas Sleep and Qais Zakaria were responsible for the investment management of Nomad whilst employed by Marathon Asset Management. Partners should note that the very nature of the transition from Marathon to Sleep, Zakaria and Company means that Zak and I are not operating with the back office infrastructure we used to receive.

**In this letter, we use the term "Partners" as a generic term referring to all Nomad investors, whether shareholders in the feeder fund or limited partners in the Partnership and not, in the strict, legal sense of the word, to imply the creation of a partnership between shareholders in the feeder fund, Nomad and/or Sleep, Zakaria and Company, Ltd.

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protection of investors nor from the Financial Services Compensation Scheme. Portfolio returns are based on the increase in net asset value per unit, and have been independently calculated by the Fund Administrator. The value of the Shares, and any income from them, may go down as well as up and an investor may not receive back, on redemption of his Shares, the amount invested. Past performance is not necessarily a guide to future performance. Neither Sleep, Zakaria and Company Ltd., nor its directors or employees warrant the accuracy, adequacy or completeness of the information contained herein and Sleep, Zakaria and Company, Ltd. expressly disclaims liability for errors or omissions in such information. No warranty of any kind implied, express or statutory is given by Sleep, Zakaria and Company, Ltd. or any of its directors or employees in connection with the information contained herein. Under no circumstances may this document, or any part thereof, be copied, reproduced or redistributed without the express permission of a director of Sleep, Zakaria and Company, Ltd. Registered office: 1a, Burnsall Street, London, SW3 3SR, England © Sleep, Zakaria and Company, Ltd.

Appendix II

Sleep, Zakaria and Company Limited.

27, Saint John's Avenue
London SW15 6AL
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As you may already know, Zak and I recently left Marathon to manage the Nomad Investment Partnership full time. In some respects this does not represent much of a change from the status quo, as Nomad had come to dominate our time and thinking. However, some things will be new, and the purpose of this letter is to set out the philosophy of our new operations. This will give you time to think about their implications before we set out the methodology in a revised prospectus. The changes in the prospectus will require your vote, and of course, at any stage Zak and I will be free to answer any questions you may have and our contact details are at the bottom of this letter.

Between us, Zak and I have spent sixteen happy years at Marathon. It was a superb education, and in many important respects working with Jeremy has made us the investors we are today. We all remain close and indeed attended the Berkshire Hathaway AGM together last week. It is perhaps indicative of the friendship and out-of-the-box, non-consensual thinking that is typical of Marathon that an amicable, common sense arrangement, such as the spin of Nomad, has been proposed. Few institutions would behave so well.

Zak and I will only be in a position to manage Nomad once we have FSA authorisation to operate as a regulated fund management company. This largely administrative process is expected to take at least three months and along with the remaining duration of our employment contracts (until June 30th) means that, at soonest, we will be in a position to run Nomad from early July. In the meantime Jeremy will be in charge and will liaise with Zak and me when appropriate. For the next two months we will be setting up a somewhat modest office (it appears that galactic headquarters is likely to be above a shop and opposite a Chinese restaurant in west London!), and configuring the necessary IT, legal and accounting systems. There will be time for research, and Jeremy has been kind enough to send on a formidable pile of annual reports! So Nomad is being looked after in the meantime.

Our new company will be called Sleep, Zakaria and Company, Limited (catchy) and we will manage one fund, the Nomad Investment Partnership. I expect this statement to be as true in twenty years time as it is today – Zak and I are not in the product diversification business. Indeed we don't really see the new company as a business in the usual way: for example we have asked our lawyers to structure the arrangement so that Zak and I could not sell Nomad to another fund manager – that way you will not

wake up with someone else managing your money whilst your manager catches a plane to Hawaii! You can sack us, but we won't sell you. Perhaps an explanation of our proposed fee scale will make clear our orientation.

The Nomad Investment Partnership currently charges a management fee of 10 basis points per annum, a levy which leans somewhat on the in-place infrastructure at Marathon and which is insufficient to sustain a stand-alone operation. We would therefore like to propose a new management fee that will reimburse the operating company (Sleep, Zakaria and Company, Limited) for its costs incurred in running the operation (salary, rent, accounting, research, legal etc). We guestimate this will be between 0.7% and 1% of the Partnership per annum at its current size, and we will cap the reimbursement at 1% of NAV and fund any deficit out of pocket if need be. Philosophically our position is that the management fee should not be a profits centre (although a small surplus float is prudent). This is not a blank cheque: Zak and I will take a salary cut to run Nomad, and a total remuneration cut that questions our sanity, but as I have said, this is not a traditional business. As the Partnership grows in size the management fee will decline as a percentage of assets and, that way, all investors share in the natural scale economics of the operation.

The performance fee also needs addressing, as there is an inconsistency between multi-year investments, multi-year orientation by investors and an annual payout for the manager! The performance fee should be appropriately calculated for the job, be at risk for subsequent poor performance and reflect the cost of capital. We will therefore propose that the existing six percent cost of capital hurdle remain (approximating five year bond rates) and that the performance fee be deferred and subject to repayment in the event of subsequent underperformance. There are several ways this could be achieved, the easiest of which may be to bank the performance fees, and for the bank to drip fees to us if performance remains reasonable, or drip reimbursements back to you to the extent we fail to maintain our advantage. One way our advantage may be compromised is if size becomes a meaningful drag on performance, as I said in the last letter to investors "*our ability to expand and shrink will be an important tool sometime in the next twenty years. I guarantee it...".* Our intention is that *"the bus is always running at full speed with the number of passengers optimised to maintain maximum speed"*, and so we will also take powers to return cash to you should we find the opportunity set is small. I don't expect that we will return cash to you that much, and I would be delighted if we did not at all, but it seems silly to set off without the ability to do so. Again, the prospectus will elaborate.

The investment philosophy and methodology will be unchanged. All that changes is that Zak and I will be dedicating one hundred percent of our time to Nomad, rather than something less than one hundred percent, and that one hundred percent of our personal investments will be in Nomad, rather than something less than one hundred percent. Otherwise it is business as usual and there will be no change in our fund administrator (Daiwa Securities Trust and Banking in Ireland) or auditor (Ernst and Young).

Zak and I are delighted that Marathon has allowed us to continue running Nomad; it is a generous gesture on their part. We are proud of what we have achieved at Nomad (as well as at Marathon) but no matter how noble Marathon's gesture is, it will mean

nothing if it is not endorsed by you. Keeping existing investors has always been more important to us than acquiring new, and this transition will only be a success if you make it so. So, I encourage you to read through the Collection of Letter to Partners sent to you in January (Amanda Joss ajoss@marathon.co.uk can help you with reprints) and the prospectus you will receive shortly. And if anything is unclear then Zak and I await your call. You may also wish to contact Karl McEneff or Martin Byrne who are the independent directors of the Nomad Investment Company and Marathon (Cayman), which is the General Partner of the Nomad Investment Partnership. Karl and Martin are superb council, and have your best interests at heart.

Zak and I are skipping happy about the new arrangements. We hope you will be too.

Yours faithfully

Nicholas Sleep

Appendix III

Sleep, Zakaria and Company Limited.

27, Saint John's Avenue
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Since Nick last wrote to you in July, he and I have been busy dotting countless i's and crossing innumerable t's allowing us to place before you the changes we would like to make to Nomad's fee arrangements and structure now that its management is to be transferred to our company, Sleep, Zakaria & Co. Ltd (SZ & Co). The changes will become part of the Nomad Investment Partnership's (NIP) new partnership agreement and it is our intention, following the handover from Marathon on the 12th of September, to put these changes before the NIP partners seeking their approval. The largest partner is, of course, the Nomad Investment Company (NIC) itself and that's why the board of NIC are writing to you to seek your authorisation to vote in favour of the changes to the NIP partnership agreement. It is part and parcel of the madness that permeates the investment world that there is no requirement that they seek your vote! But we all (Nick and I, as well as Martin Byrne and Karl McEneff, your company's two independent directors) feel it entirely appropriate that your views count. After all, we are proposing to change the contract you have with us, the basis on which we are entrusted to invest your money. Nick, Martin, Karl and I are happy and available to field any questions you have.

The Changes

First, why make these changes and why now? Nomad will move from under the wings of Marathon to our company on the 12th of September, allowing Nick and I the freedom to put into practice our philosophy to minimise wherever possible the conflict between principal and agent. This is easier said than done. It's disconcerting how invasive the conflict has become in the field of investment management (students of Jack Bogle will not need reminding) and, as you might expect, money lies at the root of this particular evil. So "job one" for Nick and I is to establish an equitable fee structure which reflects our wish that partners (the principals) and Nick and I (the agents) can sit across a table in twenty years with both sides feeling the relationship has been symmetrical and fair. Plainly, this symmetrical form bears no relation to what is now considered the fee structure norm amongst hedge funds and the like. That's fine by us, we wouldn't have it any other way.

Let me explain the changes by way of example…

First, the management fee. Currently, a simple, flat rate of 10 basis points per annum (leaning heavily on Marathon's infrastructure), this fails to pay the basic running costs of a stand-alone firm such as SZ & Co and needs to change. The question is, is a higher flat rate equitable? The answer here is plainly, no. An equitable solution is a management fee that doesn't generate a profit for SZ & Co while at the same time accreting economies of scale directly to investment performance. This is achieved by moving to a variable fee, capped at 1%, which re-coups SZ & Co's running costs while management fees, as a percentage of assets, decline as the partnership grows in size. The table below should illustrate…

Partnership assets	SZ's running costs	Management fees as a % of assets
US$50m	US$1.5m	1%
US$150m	US$1.5m	1%
US$250m	US$1.5m	0.6%
US$500m	US$1.5m	0.3%
US$500m	US$2.0m	0.4%

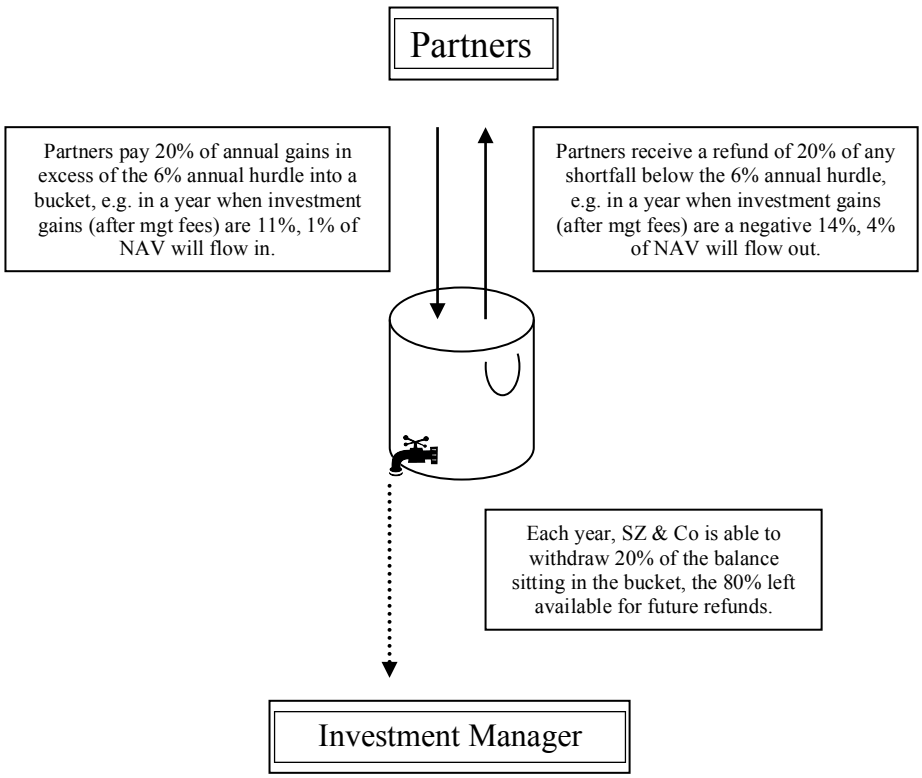
That's the simple part over… now to the performance fee. Currently the partnership pays a performance fee to the investment manager if compounded performance, since subscription, exceeds a 6% per annum hurdle, our proxy for long term deposit rates. The fee earned is one fifth (or 20%) of all investment gains in such a year. Although a huge improvement on the industry standard fee structure that fails to assign any cost to investors' capital, the flaw here is easy to spot. We take a great deal of care stressing that Nomad is an investment only suitable for partners with timeframes in excess of five years, matching our average stock holding period. At the same time, your manager is taking an annual fee, a clear mismatch in the duration of rewards. And what of periods of poor performance? Up to now Nomad has adopted the industry standard "high water mark", which solely avoids double charging investors for the same performance… this, heads-I-win, tails-I-don't-lose construct is, to our mind, clearly inequitable. But there's little out there that improves on this.

Our solution* to this quandary involves some Heath-Robertson-like innovation, something we like to call a performance fee bucket or, what our lawyers more elegantly term, a "Contingent Performance Reserve" (CPR). What we propose is that each year a 20% contingent performance fee is charged on investment gains in excess of 6% (after the management fee) achieved in that year. Unlike previously, that's not 6% compounded since subscription, it's a more demanding 6% bogie each year. And, more importantly, this fee is not paid directly to SZ & Co at the year end. Instead, it is paid into a reserve account, the CPR, the running balance of which is available to ***refund*** to partners in subsequent years when performance falls short of the 6% hurdle. So, tails we lose and rightly so. To recap, the bucket fills and empties as our investment performance exceeds or falls short of the 6% annual hurdle. So, if Nick and I do a decent job investing, over time, the money flowing into the CPR will exceed that flowing out in refunds, and a positive balance will be created.

The next stage to consider is how the CPR is distributed to our company. What we propose is that SZ & Co is paid, from the bucket, 20% of its running balance each year (on a declining balance basis). This places the performance fees you pay into the CPR at risk of refund for subsequent sub-hurdle performance for, on average, five

years. This aligns the duration of our rewards with yours. The picture below illustrates the dynamics.

*our thanks to our friends at Orbis in Bermuda who have trail-blazed this path



So, there you have the meat of the changes to the Partnership Agreement. Two secondary effects come from these changes. First, a change of fund administrator from Daiwa to Phoenix Financial Services Limited who, we feel, are best placed to deal with the bespoke nature of our new fee arrangements. We plan to take a performance fee "snapshot" at the end of September, allowing Phoenix to take on Nomad's administration with a clean sheet in October. Second, and a result of the Daiwa/Phoenix handover, is the resignation of Karl McEneff, Daiwa's representative on your board, and the appointment of Andrew Galloway as your second independent director alongside Martin Byrne. We thank Karl for his valuable guidance during the handover period and welcome Andrew on board.

We hope to complete the administrative changes to the partnership by the end of September, allowing Nick and I to return to the "day job", investing…roll on October!

Yours sincerely

Qais Zakaria

SLEEP, ZAKARIA AND COMPANY, LTD.
Investment Advisors to the Nomad Investment Partnership*
27, Saint John's Avenue
London
England

Nomad Investment Partnership

Interim Letter
For the period ended June 30th, 2006

This is the inaugural Nomad Investment Partnership letter written under the letter-heading Sleep, Zakaria and Company, Limited. The address may be temporary (it's Zak's home, office to follow in September) but Sleep, Zakaria and Company is where we expect Nomad to rest until we are all old and grey. We write this letter in our capacity as both managers of Nomad in the past, whilst employees of Marathon, and future, with the handing over of the management contact to Zak and my company effective early September 2006. For the period from our resignation from Marathon in March to the completion of the handover of Nomad in September, it is Marathon that is responsible for the portfolio. For this reason Marathon will be sending you the performance numbers under separate cover whilst Zak and I have written this commentary. This somewhat artificial separation should only be necessary for this letter whilst the handover is pending. From early September head and body will be reunited and we will assume full responsibility for your Partnership. From early September the buck stops here. We can't wait!

This interim letter will also be reasonably brief (do I hear a cheer?) as it falls between two far more important documents which require your attention: the transition letter sent in April (also contained in the appendix to this letter) which outlines the philosophy of our approach, and the prospectus, which will follow shortly, outlining the methodology. In this letter I would like to concentrate on two items, the state of the handover of Nomad to Zak and my company and second, an investment controversy.

* in waiting!

An Update on the Handover.

What's the excuse this time?
Not my fault, sir.
Whose fault is it then?
Grandma's, sir.
Grandma's? What did she do?
She died, sir.
Died?
She's seriously dead all right, sir.
That makes four grandmothers this term, Blenkinsopp.
And all on P.E. days.
I know. It's very upsetting, sir.
How many grandmothers have you got, Blenkinsopp?
Grandmothers, sir? None, sir.
You said you had four.
All dead, sir.
And what about yesterday, Blenkinsopp?
What about yesterday, sir?
You were absent yesterday.
That was the dentist, sir.
The dentist died?
No, sir. My teeth, sir.
You missed the maths test, Blenkinsopp!
I'd been looking forward to it, sir.
Right, line up for P.E.
Can't sir.
No such word as "can't", Blenkinsopp.
No kit, sir.
Where is it?
Home, sir.
What's it doing at home?
Not ironed, sir.
Couldn't you iron it?
Can't, sir.
Why not?
Bad hand, sir.
Who usually does it?
Grandma, sir.
Why couldn't she do it?
Dead, sir.

"Excuses, Excuses" by Gareth Owen.

Anyone who has attempted to set up a fund management organisation will immediately recognise Blenkinsopp. The cookie cutter nature of the fund management services industry (accounting, administration, legal, tax, information technology and so on) means that those attempting to break from the status quo come across more than their fair share of excuses. It will surprise few that our proposed refundable

performance fee is not one widely adopted by hedge or mutual funds, or indeed institutional investors, and so no off-the-shelf cookie cutter solution exists. The problem, I shall whisper this next part, may have been that in the not too distant past (that is before ninety percent of the world's hedge funds came into existence) pricing in various parts of the financial services industry may have been too low! Modest slither fee scales have changed little in a decade and ten years ago required product standardisation to stretch a clerk and his computer over many clients, in order to earn a reasonable return on capital for his bank. Today, that is, ten thousand hedge funds later, demand is white-hot and having struggled with per client economics in the early days the cookie cutters now earn super-normal profits.

This Henry Ford (any colour so long as it is black) standardisation also has a nastier side, in the sense that it stifles innovation: Hedge funds can duck the equitable performance fee question (mouth upturned they can validly and conveniently claim that 1% and 20%, 2% and 30% and so on are industry standard fee scales) whilst simultaneously the cookie-cutter accomplice earns super normal profits too. One of the world's most successful banks told us that they do not have the capacity to service Nomad's refundable performance fee scheme. A cursory glance at their accounts reveals a twenty-five percent return on equity, of which fifteen percent on equity is retained each year for the purpose of growing capacity! Hubris amongst the service providers abounds: I feel a letter to the Chairman coming on.

Sleep, Zakaria and Company Ltd., which will provide investment management advice to the Nomad Investment Partnership, has recently been authorised by the Financial Services Authority, and in what may turn out to be record time. As the usual authorisation process takes three to four months and we know of some firms that have taken one year, our four-week approval is testament to Nomad's simplicity. In one delightful exchange with the FSA they thought we had mistakenly reported in our filing an average of three trades per month (a trade is an individual purchase or sale of a stock or bond, including those triggered by subscriptions). Surely, they asked, you have missed off the noughts?…But we had not and indeed the three trades per month statistic (we did argue that we do not trade, we invest: this fell on deaf ears!) misrepresents the facts as our average holding period is around five years.

At the risk of sounding like Blenkinsopp the prospectus will be with you shortly, and we will save a discussion and explanation of its intricacies until then. Marathon's resignation of the management of Nomad (with a forty-five day notice period) and our appointment as managers immediately thereafter means that Nomad will be managed by Sleep, Zakaria and Co Ltd from September 12th. By then we should be in our new office, and there will be a new prospectus. Hooray!

We have been asked many times about reopening the Partnership, so much so that I fear we must have taken a leaf from the Hershey Creamery school of investor relations. Readers may recall that a few years ago we found it difficult to obtain Hershey Creamery annual reports or proxy statements and so we resorted to asking the CFO for a copy, only to be told "these are mailed out to our shareholders". How then might potential investors form a judgement whether they would like to become shareholders without the benefit of an annual report?

"It's a common complaint", came the reply.

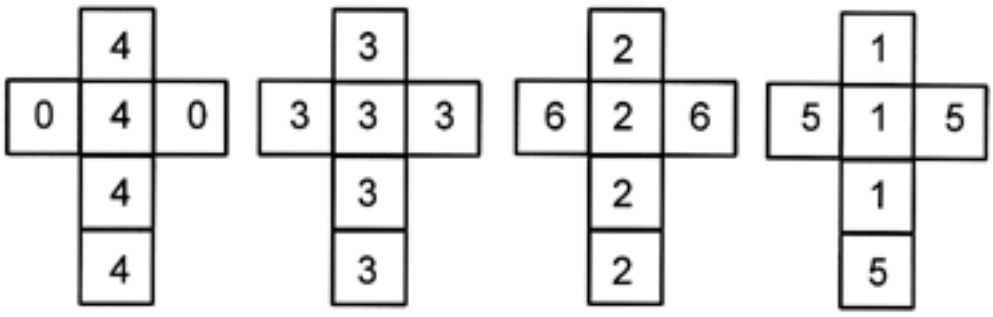
We do not mean to be so evasive, so let me explain the conditions under which we may reopen. The golden rule is that we will only reopen if incremental dollars bring something to the party, through lowering the price to value ratio of the Partnership as a whole. This aside, any increase in size is also accretive to performance as the management fee in dollars is, within certain parameters, fixed and will decline as a percentage of assets as the Partnership grows. That way growth also offers a saving to all investors. Capital raising will first take place by a rights issue to existing investors with rights not taken up returned to us and then offered to those that have indicated an interest in investing and satisfactorily completed a due diligence questionnaire. The queue is ordered with principals ranked above agents, and agents ranked according to various criteria. However, it is not ranked according to the size of the investor's pot. It is far more important to us, and our existing partners, that we all see Nomad in the same light – we simply do not have the will or inclination to offer bespoke services, cater to a different crowd or to be particularly large. When it comes to the Partnership opening we are happy to adopt the motto of the Brooklands Motor Racing Circuit whose pre-war posters showed cars speeding around its famous banked corner whilst well dressed spectators ate picnics on leafy verges, with the slogan "the right crowd, and no crowding". We are very respectful of the trust existing partners have placed in our ability to compound their savings, and have no appetite to pack in all and sundry, regardless of the incentives.

I am sure we would make poorer investments if we did, and be unhappier to boot!

When we find a pool of good ideas of reasonable size, we will be in touch. However, we will not open just because Nomad will be independent or due to some dreadful manifestation of the principal agent conflict. The cost-reimbursement management fee means we do not need to open to put bread on the table. To date, we have turned U$1 into around U$2.70. Our aim is to turn this onto U$10 within a decade (approximately fifteen percent compound per annum) and we are somewhat indifferent as to how much money we carry with us during the process: For Zak and I, it is all about the destination.

Non-Transitive Dice and some of the things they tell us about investing

If a > b and b > c, then it would normally follow that a is also > c. This is a transitive sequence and is embedded deeply in our mental problem solving apparatus. It all seems quite logical. Non-transitive, or "magic", dice challenge this assumption. A set of magic dice contains four dice whose faces are labelled as follows:



To play magic dice a host invites an opponent to choose one dice, which the opponent will roll against the host, the one with the highest number wins. The process is repeated and it's best out of ten. Some players might chose the dice with the numbers five or six, without observing the number's frequency. Others may reject the dice with zeros (surely that can't win a round?) without observing that the dice's four fours beat the number three dice two-thirds of the time. As displayed in the diagram above, the dice on the left beats the one on its right, and so on across the diagram, but the dice on the far right also beats the one of the far left! It would appear that if a > b and b > c that c is also > a!

Of course there is nothing magic about it, but at first the circularity appears counter-intuitive. A winning dice thrower must correctly assess the probability or frequency with which a dice will produce a superior number, after all a winning dice may not win on the first throw. And the dice thrower can only answer that question if first he knows what dice he is up against. The trick is to allow your opponent to unwittingly reveal some more information, and get him to pick a dice first!

Non-transitive dice offer two handy investment models: first, just as any dice can win for a while, so any superiority an investment process may have will only emerge with time, so patience is important. Second, the stock market posts prices every day, this is the equivalent of making your opponent chose his dice first. The prices the market sets reveals information about a company's prospects which may or may not provide an opportunity, it is up to investors to either take the market up on its offer, or wait for another price, another day.

The 1960 Buffett Partnership letter to investors included the following observation that we also carried in the June 2002 Nomad interim letter:

"I have pointed out that any superior record which we might accomplish should not be expected to be evidenced by a relatively constant advantage in performance compared to the Average. Rather it is likely that if such an advantage is achieved, it will be through better-than-average performance in stable or declining markets and average, or perhaps poorer-than-average performance in rising markets".

Our performance is following a similar path of superior results during market swoons and now reasonable absolute, if a little less than average, results during market booms. Indeed, the only time we have been ahead of the index year-to-date was during the market swoon in May and early June. The stock market is booming, perhaps more than is apparent in the indices as the action is taking place in lowly represented sectors and the privatisation of smaller companies (as the cycle develops this is sure to end is a truly big privatisation). There has been much market commentary offering evidence for a bubble in commodity prices and the valuation of commodity stocks. The evidence, as such, has centred on the high price of commodities compared to history, the resurgence of investment banking activity in the sector, media column inches devoted to the subject, the price of real estate in northern Alberta and so on. New Era theorists argue that China and India offer a here-to-unexperienced demand boost, whilst protagonists throw up their hands in disbelieve at commentary referring to a New Era so soon after the last ended in collapse.

What strikes us was the evidence for stock market excess: in short, something is up in the global capital markets when investors' average holding period for Phelps Dodge stock, a relatively sober copper mining company, is three months. This is not normal for any business let alone one whose assets last for decades. Investors typically hold stock for around two years, although the average mutual fund manager holds shares for around eleven months according to Vanguard founder, Jack Bogle. However, frenzied trading is not uncommon, witness six week holding periods for Yahoo in 1999, or in the Malaysian Second Section in 1997, but it is frequently associated with investor uncertainty, and speculation.

Prices are a language, and the U$20bn equity market valuation of Phelps Dodge states that, with no margin for error, the business will earn record levels of free cash flow for the best part of the next decade and with no decline (in nominal terms) in terminal value. Maybe so, but the frequency with which investors change their mind implies this is hardly a stable statement of fact. Let's be more blunt. There is an inconsistency between the multi-decade New Era-like prediction embedded in the share price, and the lack of will to see that prediction through. It is almost as if investors know it's a lie. This is not an isolated event, according to the research boutique, Empirical Research Partners, oil service companies holding periods are equally truncated and the firms are valued three or four times more highly than their customers (shades of Cisco circa 1999?).

In a traditional capital cycle framework, the high valuation of these businesses encourages a supply side response, which eventually undermines the economics discounted in the stock price. The operative word here is "eventually", so how long is eventually? Company reports this year show an expected increase in capital spending of around forty percent compared to 2005. However, in our opinion, managements tend to low-ball forward capital spending plans for fear of upsetting investors, and so it may be reasonable to expect that spending will surprise on the upside. One Wall Street guru used an American football analogy "management used to be blocking and tackling for us, now they see themselves in the glamorous receiver position". Indeed, human nature being as it is, we can almost guarantee that capital spending will continue to grow until share prices decline.

We cannot be certain when the tipping point will come. For such stocks to be a viable investment for Nomad we would have to feel confident that sector economics are not discounted in prices several years out and, given the rise in capital spending plans, that is not the way to bet. And this is Nomad's great strength. By looking out five years we do not have to invest in shorter-term phenomena in order to look good this year. And in our opinion that is at the heart of what is driving the frenzied trading in Phelps Dodge – the desire to look good this year, quarter, month, week, or just today.

When there is a frenzy of activity in one area of the market there is very often an anti-bubble of discarded companies. In the dot com era these were companies with steady cash flow. Where is today's anti-bubble? Perhaps in large high quality growth businesses that appear cheaper to us than for many years. It is for this reason that Nomad's largest holdings are dominated by traditional growth stocks, in contrast to five years ago when we owned the detritus of the New Era boom. It is interesting to note that five years ago although the most despised stocks were extremely cheap, each individual opportunity was relatively small (our investments in Stagecoach and

Midland Realty were seven-baggers but the opportunity size was perhaps U$20m each). Today the discount to fair value of the most despised stocks would appear to be much less (doubles over five years are more likely than spectacular multi-baggers) but the dollar size of each opportunity may be greater. The case for a Nomad reopening rests on this observation, and our job over the next few months will be to analyse this proposition.

We will write to you shortly introducing the new prospectus, and hopefully our change of address, new office phone numbers and so on. In the meantime, our contact details remain unchanged and are listed in the appendix. At Marathon, Amanda Joss (ajoss@marathon.co.uk) can help you with your enquiries.

As ever, it is an absolute pleasure to be associated with this Partnership. Zak and I value your confidence in us very highly and thank you for your patience.

…off to deal with Blenkinsopp.

Yours sincerely

Nicholas Sleep

* Counsel writes: In this letter, we use the term "Partners" as a generic term referring to all Nomad investors, whether shareholders in the feeder fund or limited partners in the Partnership and not, in the strict, legal sense of the word, to imply the creation of a partnership between shareholders in the feeder fund, Nomad and/or Sleep, Zakaria and Company, Ltd.

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not receive back, on redemption of his Shares, the amount invested. Past performance is not necessarily a guide to future performance. Neither Sleep, Zakaria and Company, Ltd., nor its directors or employees warrant the accuracy, adequacy or completeness of the information contained herein and Sleep, Zakaria and Company, Ltd., expressly disclaims liability for errors or omissions in such information. No warranty of any kind implied, express or statutory is given by Sleep, Zakaria and Company, Ltd., or any of its directors or employees in connection with the information contained herein. Under no circumstances may this document, or any part thereof, be copied, reproduced or redistributed without the express permission of a director of Sleep, Zakaria and Company, Ltd. Registered in England No. 5636487. Registered office: One, Saint Paul's Churchyard, London, England EC4M 8SH. © Sleep, Zakaria and Company, Ltd.

Appendix

Letter sent to Nomad Shareholders, April 2006.

As you may already know, Zak and I recently left Marathon to manage the Nomad Investment Partnership full time. In some respects this does not represent much of a change from the status quo, as Nomad had come to dominate our time and thinking. However, some things will be new, and the purpose of this letter is to set out the philosophy of our new operations. This will give you time to think about their implications before we set out the methodology in a revised prospectus. The changes in the prospectus will require your vote, and of course, at any stage Zak and I will be free to answer any questions you may have and our contact details are at the bottom of this letter.

Between us, Zak and I have spent sixteen happy years at Marathon. It was a superb education, and in many important respects working with Jeremy has made us the investors we are today. We all remain close and indeed attended the Berkshire Hathaway AGM together last week. It is perhaps indicative of the friendship and out-of-the-box, non-consensual thinking that is typical of Marathon that an amicable, common sense arrangement, such as the spin of Nomad, has been proposed. Few institutions would behave so well.

Zak and I will only be in a position to manage Nomad once we have FSA authorisation to operate as a regulated fund management company. This largely administrative process is expected to take at least three months and along with the remaining duration of our employment contracts (until June 30th) means that, at soonest, we will be in a position to run Nomad from early July. In the meantime Jeremy will be in charge and will liaise with Zak and me when appropriate. For the next two months we will be setting up a somewhat modest office (it appears that galactic headquarters is likely to be above a shop and opposite a Chinese restaurant in west London!), and configuring the necessary IT, legal and accounting systems. There will be time for research, and Jeremy has been kind enough to send on a formidable pile of annual reports! So Nomad is being looked after in the meantime.

Our new company will be called Sleep, Zakaria and Company, Limited (catchy) and we will manage one fund, the Nomad Investment Partnership. I expect this statement to be as true in twenty years time as it is today – Zak and I are not in the product diversification business. Indeed we don't really see the new company as a business in the usual way: for example we have asked our lawyers to structure the arrangement so that Zak and I could not sell Nomad to another fund manager – that way you will not wake up with someone else managing your money whilst your manager catches a plane to Hawaii! You can sack us, but we won't sell you. Perhaps an explanation of our proposed fee scale will make clear our orientation.

The Nomad Investment Partnership currently charges a management fee of 10 basis points per annum, a levy which leans somewhat on the in-place infrastructure at Marathon and which is insufficient to sustain a stand-alone operation. We would therefore like to propose a new management fee that will reimburse the operating company (Sleep, Zakaria and Company, Limited) for its costs incurred in running the

operation (salary, rent, accounting, research, legal etc). We guestimate this will be between 0.7% and 1% of the Partnership per annum at its current size, and we will cap the reimbursement at 1% of NAV and fund any deficit out of pocket if need be. Philosophically our position is that the management fee should not be a profits centre (although a small surplus float is prudent). This is not a blank cheque: Zak and I will take a salary cut to run Nomad, and a total remuneration cut that questions our sanity, but as I have said, this is not a traditional business. As the Partnership grows in size the management fee will decline as a percentage of assets and, that way, all investors share in the natural scale economics of the operation.

The performance fee also needs addressing, as there is an inconsistency between multi-year investments, multi-year orientation by investors and an annual payout for the manager! The performance fee should be appropriately calculated for the job, be at risk for subsequent poor performance and reflect the cost of capital. We will therefore propose that the existing six percent cost of capital hurdle remain (approximating five year bond rates) and that the performance fee be deferred and subject to repayment in the event of subsequent underperformance. There are several ways this could be achieved, the easiest of which may be to bank the performance fees, and for the bank to drip fees to us if performance remains reasonable, or drip reimbursements back to you to the extent we fail to maintain our advantage. One way our advantage may be compromised is if size becomes a meaningful drag on performance, as I said in the last letter to investors "*our ability to expand and shrink will be an important tool sometime in the next twenty years. I guarantee it...".* Our intention is that *"the bus is always running at full speed with the number of passengers optimised to maintain maximum speed"*, and so we will also take powers to return cash to you should we find the opportunity set is small. I don't expect that we will return cash to you that much, and I would be delighted if we did not at all, but it seems silly to set off without the ability to do so. Again, the prospectus will elaborate.

The investment philosophy and methodology will be unchanged. All that changes is that Zak and I will be dedicating one hundred percent of our time to Nomad, rather than something less than one hundred percent, and that one hundred percent of our personal investments will be in Nomad, rather than something less than one hundred percent. Otherwise it is business as usual and there will be no change in our fund administrator (Daiwa Securities Trust and Banking in Ireland) or auditor (Ernst and Young).

Zak and I are delighted that Marathon has allowed us to continue running Nomad; it is a generous gesture on their part. We are proud of what we have achieved at Nomad (as well as at Marathon) but no matter how noble Marathon's gesture is, it will mean nothing if it is not endorsed by you. Keeping existing investors has always been more important to us than acquiring new, and this transition will only be a success if you make it so. So, I encourage you to read through the Collection of Letter to Partners sent to you in January (Amanda Joss ajoss@marathon.co.uk can help you with reprints) and the prospectus you will receive shortly. And if anything is unclear then Zak and I await your call. You may also wish to contact Karl McEneff or Martin Byrne who are the independent directors of the Nomad Investment Company and Marathon (Cayman), which is the General Partner of the Nomad Investment Partnership. Karl and Martin are superb council, and have your best interests at heart.

Zak and I are skipping happy about the new arrangements. We hope you will be too.

Yours faithfully

Nicholas Sleep

Enc. Contact details

Contact details

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Nomad Investment Partnership

Annual Letter
For the period ended December 31st, 2005

To Dec. 31st, 2005	Nomad Investment Partnership	MSCI World Index (net) US$
One year	+9.2%	+9.5%
Two years	+33.3	+25.6
Three years	+139.5	+67.2
Four years	+142.6	+33.9
Since inception (Sept. 10th 2001)	+167.2	+38.8
Annualized since inception		
Before performance fees	+25.6%	+7.9%
After performance fees	+21.4%	

The figures above are presented on a cumulative basis (for the "A" shares, after allowing for management fees and the cost of running the Partnership (auditors, administration, custody etc.) but before performance fees. We present results in this way as performance fees are earned once returns exceed 6% compound per annum from the time of subscription, and therefore net returns can vary from investor to investor). A large global index is also presented to place Partnership results in context, and inception refers to opening prices on the 10th. Overleaf the same results are presented in discrete annual increments. In our opinion, it is the table above that is most useful in assessing long-term investment performance (see appendix).

To Dec. 31st, 2005:	Nomad Investment Partnership	MSCI World Index (net) US$
Six months	+6.8	+10.3
2005	+9.2	+9.5
2004	+22.1	+14.7
2003	+79.6	+33.1
2002	+1.3	-19.9
2001 (inception Sept. 10th 2001)	+10.1	+3.6

2005 was the fifth calendar year of the Partnership's operation and since inception we have turned U$1 into U$2.67 before performance fees and approximately U$2.30 after fees, compared to a gain of around U$0.39 for the average, one dollar stock over the same period. It is aesthetically annoying to under-perform a broad global stock market index by a piddley amount as we did last year (if you are going to under perform, do it properly!) but given the concentration and eclectic composition of our Partnership (ten stocks account for around 70% of the Partnership, with operations from Seattle to Harare and Huddersfield to Manila) it is perhaps a little anomalous that we should be anywhere near the index at all, with its 1,801 large stocks. Indeed, according to a maths guru at a large investment bank the chance of Partnership results being as close to the index as they were last year, given the disparity of holdings, was once in a long lifetime (approximately one year in seventy). Make of that statistic what you will, but even so we are now within stabbing distance of tripling the original dollar in our first five years. Contrast this with poor Bill Ruane who launched his Sequoia Fund straight into the nifty-fifty two tier market of the early 1970s, with the effect that at the end of his fifth year cumulative returns were close to zero! Can you imagine such a fund surviving in today's business oriented investment world? So that there is no confusion: we are not more skilled than Bill Ruane.

Our starting point has been more fortunate.

In our opinion, there have been two outstanding periods to make investments in the last ten years: Asia, in the aftermath of the Asian crisis, and during the US junk bond crisis which immediately followed the Partnership's launch. We therefore walked straight into a super opportunity set and our results reflect that. However, there is not much distress around today (Zimbabwe excepted) and continuing to compound at 25% per annum, without the requisite amount of investor distress necessary to create good prices, is improbable. As we have said in previous letters "*no extrapolation of results, please: that is just a recipe for everyone to get upset*".

In May 2004, we drew down part of the queue that was waiting to invest in Nomad, and since then the Partnership has gained around 35%, compared to a gain of around 25% for most stocks. When we look back at the investments we made, there was, in practice, a very high limit to the amount of money we could have invested and still maintained performance. Several hundred million dollars could have been invested in each of Costco (US), New World Developments (Hong Kong), Amazon.com (US), Telewest (UK) and Liberty Media (Europe and Japan). But as each idea came one at a time, with a lag in between, we were reluctant to open the Partnership for the sake of one new idea. We erred on the side of investment performance rather than maximising fund size. I know this is not how the industry thinks and behaves, but at Nomad we see our job as running an investment partnership first and commercial enterprise

second. Which raises an interesting wrinkle: if we had opened Nomad, drawn down the whole queue, and invested the capital well, then in five years time Nomad would be billions of dollars in size. Say we then found that the opportunity set was small: could we give the money back?

There is a difference between investment returns measured as a percentage gain, and results when measured in dollars. Doubling a hundred dollars through stock picking is not economically equivalent to a ten percent gain on a thousand dollars, although the dollar profits are the same. It is for this reason that investment results are rightly presented in percentage terms, however, in some respects this is only half the equation, as doubling a billion dollars is clearly a better outcome than doubling a hundred dollars. The key ingredient for evaluating the case for taking on more funds must be that the incremental, new dollars do not inhibit performance in percentage terms for the first dollars. That way the bus is always running at full speed with the number of passenger optimised to maintain maximum speed. The industry skirts around this point and talks about relative performance instead, as commercial pressures encourage lesser performance on vastly increased pools than better performance on smaller pools. It is as if the industry aspires to run the equivalent of the Calcutta commuter bus, so burdened with paying passengers piled on the roof that all it can manage is to trundle, unsafely, in the slow lane!

But let's turn the proposition on its head: the intrinsically low cost structure of the investment business, so often used to earn super normal profits for business owners, would instead allow a shrinking of the investment pool for the purpose of protecting investment returns. I don't think many managers have thought about it this way, most in the industry have taken to heart Winston Churchill's instruction to "*keep buggering on*". They hope that declining returns go unnoticed, and besides, they argue, who knows how fast the bus would be going if they let some passengers off. But what we are asking is, in practice, how would you feel about us returning capital to you on investment grounds? At Nomad we hope that it would never come to that, but it may. And it is important that we all understand a road map that allows for a shrinkage before we first grow the Partnership. And to add another layer of complexity, how would you feel about us changing our mind some time thereafter if the opportunity set improved markedly and we could take more money? This raises the interesting notion that if we returned capital to you would Zak and I have some moral responsibility for the dividended funds? I think we might. In other words, as investment results are maximised by Nomad expanding and contracting with the opportunity set, how can we reflect this reality in the structure of our Partnership? It's amazing to us that most investment companies are silent on such an obvious, common sense issue, but such is industry obfuscation of uncomfortable facts these issues go undiscussed. Even so, our ability to expand and shrink will be an important tool sometime in the next twenty years. I guarantee it. And it seems silly to set off without it. I would value your thoughts on this greatly.

<u>More on the principal/agent conflict</u>

What I am describing is one aspect of the principal agent conflict, that is, the interests of you, the principals, are different from ours, your manager, the agent. There are two ways to approach this situation: 1. maximise the conflict for the sake of maximising short-term agent revenues (standard industry practice), or 2. set about minimising the

difference through behaving and thinking like principals. Zak and I have followed the second path. I know we are agents by virtue of the Nomad performance fee and perhaps that is the lot of young men with mortgages and families. But I do not think it is our natural disposition. There comes a point when turbo charging is counter-productive and there will come a day when we will be able to waive the performance fee. Before you start rubbing your hands, it's not around the corner, no really, it isn't! But we mention this in writing now so that hopefully you will remind us of it in years to come, and hold us to account! Our motivation is to do a good job. If we do that then the mortgages will take care of themselves.

Which brings me to the subject of the existing performance fee. Eagle-eyed investors will not have failed but notice the near 200 basis point difference between gross and net performance this year, reflecting the performance fee earned. We are in this position because performance for all investors is in excess of 6% per annum compounded. But given historic performance, that may be the case for a very long time. Indeed we are so far ahead of the hurdle that if the Partnership now earned pass book rates of return, say 5% per annum, we would continue to "earn" 20% performance fees (1% of assets) for thirty years, that is, until the hurdle caught up with actual results. During those thirty years, which would see me through to retirement, we would have added no value over the money market rates you can earn yourself but we would still have been paid a "performance fee". We are only in this position because we have done so well, and one could argue that contractually we have earned the right by dint of performance, but just look at the conflicts!

Given the incentives, we should buy treasuries, and to keep us on our toes, you should rightly withdraw your investment and immediately reinvest to reset the base line. That's not the relationship we want. Now, we are not going to buy treasuries (at least not for that reason), or equities that look like treasuries for that matter (check your other managers for those!) and to your great credit, no one has tried to game the system through withdrawing and reinvesting, and we would be mortified if you did. And given the way both investors and your manager appear to think and behave, I may be guilty of fixing a problem that does not exist. But even so, and at the risk of a belt and braces approach, I would like to propose that from this year the performance fee be amended so that the high water mark also compounds at 6% per annum, and I will write to you shortly to ask approval for that amendment to the prospectus. That way each new year has a hurdle of 6%, and the hypothetical pass book return goes unrewarded. No one has criticised the status quo. We are under no pressure to change anything. But I simply do not want to earn a "performance fee" if future returns are below 6% each year, that is not what we are about, and I want to be able to shave in peace in the morning!

Comparative Advantage Revisited

It is an interesting psychological phenomenon to observe that if our annual results were reordered, we might feel differently about them. For example, place the results in descending order (+80%, +22%, +10%, +9%, +1%) and one is depressed by the decline; place them in ascending order (+1%...+80%), and we tend to think of them more favourably, even though the end result (the destination) is identical. Recent success feels better than distant success, as the brain perceives recent rewards more vividly. Psychologists call this the "availability heuristic" and it is this phenomenon

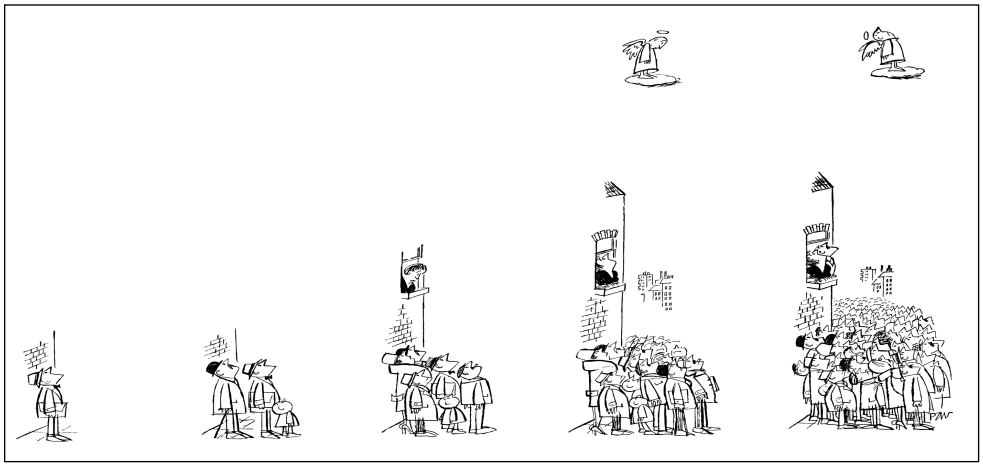
that has sold a thousand mediocre mutual funds that appear, momentarily, to have a pulse! But that is not the way to invest. Annual results will bounce around all over the place, and for Nomad more so than more diversified funds. But does that matter if the destination is secure? Indeed, if we could turn U$1 into U$16, does it matter if it takes 18 years or 22 years? There is a difference in the annual compound rate of appreciation (over 3% per annum, and I do not wish to make light of that), but securing the destination is also important.

And securing the destination is much harder to do if you are trying to beat the index in annual increments at the same time. Nassim Nicholas Taleb (author of "Fooled by Randomness") published an interesting paper (free, on the internet) which also linked the sequence in which returns occurred to how they made investors feel. He argued that investors often accept the risk of an occasional large loss for a steady small profit as the recurrence of the gains made them feel better. This occurred even when an opposite strategy, of steady small losses followed by a large gain, generated superior end results. Travelling comfortably dominates people's thinking when they should be thinking about destinations.

To our way of thinking the question is, what good habits and techniques ensure that the destination is secure (even if the ride is bumpy), and that U$16 will be realised? This comes down to the sustainability of an investor's comparative advantage. In the last letter we discussed the comparative advantages an investor may have. To recall, "*there are three competitive advantages in investing: informational (I know a meaningful fact nobody else does); analytical (I have cut up the public information to arrive at a superior conclusion) and psychological (that is to say, behavioural).*" We concluded that the enduring advantages are mainly psychological. In this letter I thought I might describe some of the largest, common psychological causes of investor misjudgement, and apply these to some of our investments.

Social Proof/Group psychology.

We all know that social decisions can be suboptimal, but even so, that is how most decisions are made. In the last letter we reproduced one of our favourite Punch cartoons and make no apologies for doing so again here.



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Look at the angel in the last frame: think of her as a metaphor for the investment management industry. We sit at the top of the capitalist pyramid, collecting our rent from the layers below, and we should be thinking differently from the crowd. We should behave with some integrity. But what is the angel doing? Stanley Milgram performed an experiment very similar to the Punch cartoon and found that as the size of the crowd increased, so the proportion of passers-by that stopped and looked up increased too. I have not seen the study but I bet the relationship wasn't linear, that instead it had these step functions to it. No one stops if there's just one guy standing there, but perhaps a group of three would get some passers by looking up, and by the time it's a big group almost everyone is stopping: that's the way it works in the markets. Witness the waves of massive overinvestment such as occurred in the Thai cement industry in the mid 1990s, and the US telecom and technology companies in the late 1990s. It appears to us that once one company starts building they all do through fear of missing out. Once Siam Cement had built all the capacity Thailand could need there was no need for Siam City Cement to join in. Let alone TPI Polene. But they all went mad. Combine social proof with envy and the financial incentives available in the stock market and that's a recipe for a sizeable mistake.

Availability

A second source of misjudgement is availability, or the tendency to over-weight the vivid evidence or the evidence easily obtained. We discussed this somewhat above in relation to annual performance. We all do this to some extent, as the tendency is to concentrate at the task in hand, and miss the bigger picture. Looking around you is the most important skill, and is largely innate, although Professor John Stilgoe at Harvard is trying to teach it and wrote an interesting book recently entitled "Outside Lies Magic". In the markets investors tend to latch on to what can be measured, aided by the accountants and to some extent by their own laziness. But there is a wealth of information in items expensed by accountants, such as advertising, marketing and research and development, or in items auditors ignore entirely such as product integrity, product life cycles, market share and management character (this is not an exhaustive list!).

Probability based thinking

Third is an inability to perform probability based thinking. In one of Charlie Munger's talks he makes the statement *"the right way to think is the way Zeckhauser plays bridge, it's just that simple*". Well, to a young man in London that is a very infuriating statement as it took me about a year to track down Richard Zeckhauser. He was world bridge champion in '66 and, amongst other things, now runs a brilliant Behavioural Finance course at the Kennedy School of Government at Harvard. So, how does he play bridge? He thinks via decision trees and attaches probabilities to the various branches. And as the facts change, change the probabilities. And when you are comfortable dealing with probabilities, and the vast expanse of opportunities such as the global stock and bond markets, you don't have to be too conservative with your bets.

But people don't think clearly when faced with probability trees. Take the following example, one person in a thousand suffers from a particular disease. The test for that

disease is 99% accurate. What is the chance that your friend, who has tested positive for the disease, actually has the disease? The answer is one in eleven. However many people mistakenly think the answer is one in a hundred (hint for the confused: one in a hundred is the accuracy of the test). As the tests aren't as accurate as they sound, and many doctors miscalculate the probabilities of disease, the General Medical Council (in the UK) requires that doctors test for dreadful diseases like HIV twice! Understanding the value of a company involves assessing the likely outcomes given management behaviour and competitive forces, and weighing the probable outcomes in a valuation. So an inability to arrange outcomes in probabilities is a considerable error causing bias in investors decision making processes and is behind many mis-valuations.

Patience

Finally, patience, or the lack thereof. At the beginning of the annual general meeting of the Berkshire Hathaway Company they show a video in which Buffett is asked what is the main difference between himself and the average investor, and he answers "*patience*". There is so little of it about these days: has anyone heard of getting rich slowly? Jack Bogle, founder of the Vanguard Group, claims that the holding period for stocks is down to 10 months and the average mutual fund is held for 2 years. What's that all about? And this behaviour feeds back into how managers report to their clients, to the extent that quarterly reporting borders on an obsessive compulsive disorder. And how did we get to this state of affairs?

I think the problem is that two agents, the fund manager and his immediate client, try to eek out some value added in the mind of their clients, and it creates these counter productive consequences. Few people honestly believe this is the right way to behave, but they think that is what is expected of them by others, and so a spiral of dysfunctional behaviour is established. You would never get this level of reporting nonsense if it was on a principal to principal basis! And who is to blame? I side against the investment institutions. These are largely rich organisations and should behave with integrity, not bow to dysfunctional requests. And it is so unnecessary: as investors we own the only permanent capital in a company's capital structure, everything else in the company: management, assets, board, employees, can change but, absent bankruptcy, our equity will still be there! Institutional investors have never really reconciled their ability to trade daily with the permanence of equity. Are they long-term or short-term?

A worked example of Current Institutional Dysfunctionality

Our returns over the next twenty years will, in part, be derived as a consequence of the failings of the institutions that dominate the markets. The good news is these companies are stuffed with internal rules and contradictions necessary for them to perform as businesses but which foster the psychological mistakes mentioned above that compromise investment returns. Take an institutional favourite, liquidity (the amount of shares of a company that trade on the stock market, crucially this is usually measured over a short time period). The institutional desire is to have high liquidity, it appears, so to lower the probability of being caught in a poorly performing share, and dare we say, having to explain that to clients and their agents (another strike for the

principal agent conflict)! Being in the wrong stock strikes me as an analytical mistake, not a liquidity mistake (if there is such a thing), and hiding analytical mistakes through selling shares in my opinion borders on fraud. But even so, the point is that companies with poor liquidity can be sold by institutions because they have poor liquidity and regardless of price, and that creates opportunities for those less constrained. Take for example one of our holdings, Matichon Pcl, a Thai newspaper which we described in the first Nomad letter to Partners as follows:

"*We do not read Thai and take it on trust from Thai friends that the editorial content is pro-reform and it is certainly tabloid in style which sets it aside from Thailand's largest newspaper (Thai Rat) which is more "old Thailand". Matichon is probably not the Washington Post, but it's healthily questioning nonetheless".*

Perhaps a little too "*healthily questioning*" as, in September last year, the firm was subject to a takeover attempt backed by, it is reported, the Thai Prime Minister, who had been regularly criticised in Matichon's pages! The offer was debt financed and orchestrated through another local media business which was making the bid. In the weeks before the attempted takeover we were approached by several other sizeable shareholders and asked if we wished to sell our shares in a block with theirs to the bidding party. We were a little surprised at the role reversal, as one might expect the bidding party to make the pitch, not one's fellow shareholders, and besides the price seemed low!

What could these other institutions be thinking? There had been no analytical mistake, we had all done quite well with our Matichon holdings, and yet as the stock had become increasingly illiquid (in part because we all owned so much of the company) one of our fellow shareholders confessed to us that there was a business pressure to sell, and it was for this reason they had called us. Just look at the psychological mistakes these institutions may be making, their thinking would appear to be as follows: the stock has risen in price so it is OK to sell (vivid evidence), our peers want to sell (social proof), therefore it must be OK for us to sell too (group psychology), there is a business reason to sell (principal agent conflict), the shares are illiquid (vivid evidence), we do not want to get stuck in an illiquid holding (impatience, more principal agent conflict and poor probability based thinking – highly priced shares are rarely illiquid!).

To our way of thinking in-market insiders buying on leverage are unlikely to provide the highest offer for our shares, and we declined on the grounds that the economics of buying looked good to us! But everyone else sold, except it seems Nomad, the company founder, allegedly the Thai Prime Minister and his associates, and other members of management. Following the institutional exit the firm has begun a sizeable share repurchase program, not good for liquidity perhaps, but the repurchase program does imply a healthy compounding of value per share for the remaining owners. Time will tell whether these investment institutions were right to sell but, if they turn out to be, it will be for the wrong reason: they did not make an investment decision, they sold because it was commercially expedient, and that may be to our great advantage.

Our work for the next period

We are very conscious of the destination (U$16 after twenty years), and raising the probability of reaching the destination involves understanding the psychological mistakes mentioned above and thinking in evolutionary terms to stay ahead of the crowd. If people learn and the economy is adaptive one would expect that over time price anomalies may diminish. You might have thought people would notice! But it is also true that some of the behavioural mistakes listed above are as old as the stars and were as valid when Graham wrote the first edition of Security Analysis in 1934 as they are today. Indeed it is quite possible, in our opinion, that today's business oriented investment world is leading to a widening of the principal agent conflict and this may increase the psychological mistakes investors make. If so, the opportunity set should be increasing. This may be conjecture on our part, but that seems to be the way the industry is going. Know of any hedge funds that own stocks long-term? That want to own illiquid stock? That don't price gouge? And we are told these guys are the future! At its heart we are trying to be people of good judgement and do intelligent things with money and this necessitates that our stock picks are contrarian. This approach has served us well in the first five years. But we regard it as only a start, and if we are to turn U$1 into U$16 over 20 years, which would be stunning, then sitting at just below U$3, as we do today, is not much to crow about. There is still much to do.

Matichon is one of six Nomad investments that have been bid for in the last eighteen months! By number that is one quarter of the portfolio. And whilst most of these have either failed (Brierley and Matichon), are pending (Telewest) or remain somewhat inconclusive (Thorntons and Holcim Philippines which is in dispute in the high court) there is likely to be some recycling of investments in the coming period and we remain vigilant for stocks that others despise. It was put to us recently that we have a "*told you so*" portfolio (stocks which others will be dying to point out the idiocy thereof) and that pretty much sums it up. The task in hand is to find some more *"everybody knows that's a bad idea"* stocks.

Thank you

Attached to this letter is the transcript of a speech I gave recently which relates some of the psychological traps mentioned above to our experience of investing in Asia (more punishment for the curious). I have also attached a copy of the Nomad Letters to Partners since inception. That is an awful lot of reading. Don't worry there will not be a test, but having everything in one place is usually helpful, especially as we often refer to previous letters.

Make no mistake of the role you play in any success the Partnership may have. We are simply delighted that you have let us get on with driving the bus (not always successfully) free of noisy passengers. We are pursuing the road less traveled in both stock picking and Partnership governance and conscious that that requires some effort on your part to stay the course with us. As such we are not an easy ride, but we are respectful of the effort you put in and I promise that we do not take your confidence in us lightly. Thank you. The destination will be worth it.

Zak and I love running the Partnership. Truth be told, perhaps a little too much! To our minds it is what investing should be.

The annual report pile now threatens the light levels in our office, and the annual general meeting season awaits…

Yours sincerely

Nicholas Sleep

· Marathon Counsel writes: In this letter, we use the term "Partners" as a generic term referring to all Nomad investors, whether shareholders in the feeder fund or limited partners in the Partnership and not, in the strict, legal sense of the word, to imply the creation of a partnership between shareholders in the feeder fund, Nomad and/or Marathon Asset Management.

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Speech given to the board of The Investment Fund for Foundations at the invitation of Mike Costa and David Salem, September 26th 2005, New York City.

"So, how does Zeckhauser play bridge?"

In his brief for this talk, Mike asked me to talk about emerging markets. This may have something to do with my firms' track record of investing in emerging markets, principally south east Asia, but also serendipitously in places like South Africa and Mexico. When I sat down and started writing, I found that I had a lot to say. I tried to cut it down a little, but it lost something. Now if I was a great orator, like Bill Clinton, perhaps I could deliver my talk off the cuff and look cool and nonchalant? But the truth is I pick stocks for a vocation, and that puts me at the geek end of the spectrum: so if you will forgive me, for the most part I will read what I have to say. Some of this stuff is important and I want you to understand it.

In main established markets of the world our output, that is to say our track record, has been to beat the indices in almost all geographies, over almost all time frames by 4 to 500 basis points per annum. But if one burrows down to look at our experience in emerging markets it is much, much better than that. And that is a very interesting phenomenon. I mean how is it that three guys (Jeremy, Zak and myself) in a room in London, doing broadly what we do elsewhere in the world do much better in one territory than in the other? And how is it that we have done better than our peers with armies of analysts stationed in capitol cities throughout the region? I mean, how can this be? And how sustainable is it? And as you have money invested with us, I am sure you will want to know how sustainable it is too!

At this point I should probably explain something about my background. I studied Geography at Edinburgh University, Scotland. Geography is a subject that hardly exists in north America. A Harvard Professor once told me that they had a Geography course at Harvard but it had a reputation for homosexual lecturers and was closed down. I am not sure what to make of that particularly, I suspect it is not cause and effect, but at any rate Geography is a subject with an identity crisis – it is the confluence of geology, physics, chemistry, oceanography, climatology, biology and that is just physical geography. Human geography deals with sociology, psychology, statistics, economics – so it is the ultimate polymath course. Geography just reached in to other subjects and grabbed what it thought it had to have. Indeed the reason I studied Geography at all was because of this polymathic quality although I got there through an odd route…

I went to Edinburgh to study Geology, because that's where the best Geology course was, and in my first year I developed an interest in Architecture and IT but I was discouraged from studying these off subject courses by the Geology department who thought I ought to be doing the hard sciences, and so I transferred to Geography and began a dissertation of architecture and business parks! But because Geography is so broad, it claims little territory of its own, that's why Harvard closed it down, and at various times in its history the subject goes through identity crises. Because Geography is seen as an academic gate-crasher practitioners have had to ask themselves questions that other more homogenous subjects such as physics or chemistry have not.

And so at Edinburgh we spent a whole year on the philosophy and methodology of what we were doing, and that year opened my eyes. I just loved it.. I mean it really changed my thinking. And I was reading "Zen and the Art of Motorcycle Maintenance" by Robert Pirsig at the time, and the two just combined to change how I viewed the world. So I have this tendency to return to the basic questions. And what I am going to do here is talk about the philosophy and methodology of what we do as investors, and assess why performance is better in Asia as a logical subset of a much more important question, which is "what is your competitive advantage in investing?"

Bill Miller was asked that question recently and gave the following answer: there are broadly three advantages one may have: informational, analytical and psychological:

An informational advantage would be that I know a piece of information that the market does not, and that information has value. Nathaniel Rothschild built one of Europe's great banking fortunes that way. He had faster couriers and carrier pigeons than everyone else, and everyone knew that, and so he was first to market with the knowledge of the war won (or lost). And because everyone knew that he knew, it was hard for him to fail. That advantage is pretty much dissipated today. It is either illegal following insider trading and Reg FD like regulations, or the information is instantaneous and omnipresent. I have tried not to look, but I guess some of you will have checked your blackberries since I started talking?

The second is analytical, that is one can cut up the information everyone else has in a different way to arrive at different conclusions. Lets see what Wittgenstein had to say on the subject. **Slide 2.** Wittgenstein's point is the description you use, will frame how you think? So is it a coat hanger or a door wedge? If someone described it to you as a piece of cheese, you would think about it differently than if they had told it was a mountain, or a pyramid that's fallen over. The point is that perceptions change as descriptions change – and they change independent of the facts. My favourite example here is the way advertising and marketing budgets are treated in public accounts. That is they are expensed as a debit to earnings. Because the accountants have this sound overriding bias to draw up accounts with reference to conservative values, and don't know how to capitalise it, its valued at nil. Estee Lauder has a huge advertising and marketing budget which dominates its profits statements. So much so that the residual cash flow that drops down to the profits of the business is almost a rounding error on the larger amount. But its that little residual that the markets use to value the company.

In the case of the Estee Lauder Company the share price fell! when they announced a rise in the ad spend. In other words the market viewed "all costs as bad costs" – well they had to have been buying something with the money! And so the question is: what have Estee Lauder bought with that advertising budget? Ditto Nike, Coke or one of our investments, Scotts Miracle Grow. And this factor goes on again and again. And it can be applied to other expensed investment spending such as R&D. So we do a fair amount of turning numbers around, looking at things no one else looks at, such as share of voice versus share of market, which is a way of assessing advertising spend, we assess customer loyalty, we covering up the name of the company and analyse the business and so on.

You have to array the information in such a way as to be able to properly weigh its value, and that is not always the same way the accountants use. And I think we have some analytical advantage in that compared to the crowd. But I like it most when it is combined with the final source of competitive advantage and those are…

Behavioural and psychological. At this stage my talk could turn into a variant of Charlie Munger's "Psychology of Human Misjudgement" speech given at the Harvard Law School in the mid 1990s and which is the finest investment speech ever given. Not that he talked directly about investments. And that tells you something. But the most enduring advantages are psychological. And the trick here is to first understand them. And then train yourself out of them!

Well the list here is just so many: over-confidence, incentives, commitment and consistency tendency, deprival super-reaction, anchoring, jealousy/envy, I could go on and on, and Charlie had 24! But what I will do here is focus on four that I think lead to more misjudgements than most, especially when they combine with each other.

First, Social Proof/Group psychology. Well we all know something about the dysfunctionality of group based decision making, you've got one guy leading the debate, he's the authority figure, he suggests a course of action, everyone anchors off that suggestion, maybe bonus time is looming so no one wants to object. You are all aware that a competitor across the road has just taken the same course of action. And nobody objected. Social Proof. And of course it's a perfect disaster. We all know that social decisions can be suboptimal, but even so, that is how most decisions are made… At least on the boards of public companies and investment firms I know.

Slide 3. This is a chance to bring in one of my favourite cartoons which was carried in the book "Influence: The Psychology of Persuasion" by Bob Cialdini. I can't look at this cartoon without seeing that angel as a metaphor for the investment management industry. We sit at the top of the capitalist pyramid, collecting our rent from the layers below, and we should be thinking differently from the crowd. We should behave with some integrity. But what is the angel doing? …I was at a Santa Fe Institute meeting the other day, and Jim Surowiecki the author of "the Wisdom of Crowds" told me that Stanley Milgram actually performed this as an experiment. And what he found was, as the size of the crowd increased, so the proportion of passers-by that stopped and looked up, at nothing, increased too. I have not seen the study but I bet the relationship wasn't linear. That it had these step functions to it. No one stops if there's just one guy standing there, but perhaps a group of three would get some passers by looking up…and by the time it's a big group almost everyone is stopping…anyhow, that's the way it works in the markets…

In Cialdini's book he talks about the unhappy case of Kitty Genovese who was slowly murdered whilst people just stood by watching each other? And because no one was running to her aid no one else did?

And how many people bought tech stocks in 1999 because everyone else was?

How else do you explain how you get these waves of massive overinvestment such as occurred in the Thai cement industry in the mid 1990s. In my opinion what happens is once one company starts building they all do through fear of missing out. Once Siam

Cement had built all the capacity Thailand could need there was no need for Siam City Cement to join in. Let alone TPI Polene. But they all went mad. Combine social proof with envy jealousy, and financial incentives and boom, there you go.

My second source of misjudgement is availability, or the tendency to over-weight the vivid evidence or the evidence easily obtained. Here my favourite example is given by Dick Thaler, who runs an investment company and teaches behavioural finance at the Chicago School of Business. And Dick uses a short video clip of 20 seconds or so, which shows three people dressed in white and three people dressed in back. And each team passes a ball between them whilst moving around the floor. And Dick asks, count the number of passes made by the white team. At the end he asks the audience how many passes they observed. 18? A few hands. 19? More hands. 20 and so on. It is interesting that we cant all agree on that! That tells you something. Then he asks did anybody see anything else? Now I have seen this done a few times now and in only one class did someone spot what actually happened. Dick asks, did anyone see a man dressed in a gorilla suit walk into the middle of the screen beat his chest and walk off?! Almost no one sees this.

Well we all do this to some extent. We tend to look hard at the task in hand and miss the bigger picture. Looking around you is the most important skill, and is largely innate, although Prof. John Stilgoe who is also at Harvard is trying to teach it and wrote an interesting book recently entitled "Outside Lies Magic". And in the markets investors tend to latch on to what can be measured, aided by the accountants as we discussed just now and to some extent by their own laziness.

The adage that "*if its in the headlines its in the price*" is very largely correct. I mean who would want to put up with this. **Slide 4.** There are over 640,000 headlines under Xerox and bankruptcy on Google! I know investors that screen for that by the way, but there are not too many people that want to own the most despised company in the market, which any Joe on the street that reads a newspaper knows is in some kind of trouble, as anyone who has owned Asia at the pit, or Xerox, Lucent and Primedia these last few years will know.

My third misjudgement is from an inability to perform probability based thinking. In one of Charlie Munger's talks he makes the statement *"the right way to think is the way Zeckhauser plays bridge, its just that simple*". Well, to a young man in London that is a very infuriating statement. I mean, who is Zeckhauser, and how does he play bridge? Well it took me about a year to track down Richard Zeckhauser and answer that question.

He was world bridge champion in '66 and runs a brilliant Behavioural Finance course at the Kennedy School of Government at Harvard. And the reason that his course is at the Kennedy School at all is very interesting. I mean what is a Behavioural Finance course doing at a "School of Government" in the first place? Well, the reason is that his course was rejected by the deans of the economics department who claimed it was not economics. Instead he took the course to the Kennedy School where it has been held ever since.

Zeckhauser's split with the economists' view of the world is their reliance on a rational utility-maximising framework. The old guard are hostile to assertions of non-

rational behaviour, I mean the idea that we are all rational is just so beautiful, as I'm sure Ayn Rand would agree. Well this does not sit easily with the psychologists' view of the world that there are systematic biases to individual decisions – that is we have these little wobbles in our decision making processes. Or a biologist's view of the world that individuals act in self-interest, make mistakes, learn and evolve. Well Brian Arthur at the Santa Fe Institute refers to the economy as a complex adaptive system that learns as agents learn. And that seems like a way better model to me…

So, Behavioural Finance takes a pragmatic, multidisciplinary approach (a little like Geography!) and puts the rational economists' view of the world together with that of the psychologist and biologist. After all how can economics not be behavioural – who is making the decisions after all?

It is my personal opinion that the thinking presented by Zeckhauser, and at the Santa Fe Institute should be thought of as the new economics in waiting, but it will likely only become mainstream consensus once the old guard has died off. The fact that these courses are still considered Moonie conventions and are rejected by the Harvard economics department shows how far away establishment, consensus thinking is. I am aware of only one large fund management organisation that has internalised these ideas and when Zak and I joined the Santa Fe Institute last year we represented only the second European investment company to do so.

And even we have trouble getting these ideas adopted – there is a tendency for people to say "thanks Nick, that behavioural finance stuff was really great", but then they go back to their desks and carry on as they did before. Articulating this stuff is easy, internalising it is not. That's the hard work. Einstein's theory that space and time were relative had already been thought of by Lorenz. But what Einstein did was put it central to everything – whilst everyone else kept the concept peripheral. And it changed the word. That's how behaviour finance should be used. But it probably wont…Murray Gell-Mann at the Santa Fe Institute is fond of saying "one scientist would rather use another's toothbrush than his nomenclature". But those that can adopt these ideas will be streaks ahead of the competition in my opinion. But I'll come to that later.

So, anyhow, how does Zeckhauser play bridge? Well he thinks via decision trees and attaches probabilities to the various branches. And as the facts change, change the probabilities. Now I've been droning on a bit, so let me say it again, because its key…Zeckhauser thinks via decision trees and attaches probabilities to the various branches. And when you are dealing with probabilities you can be indifferent to gain or loss outcomes, but that's normally a trained response. And when you are dealing with probabilities, and the vast expanse of opportunities such as the global stock and bond markets, you don't have to be too conservative with your bets.

But people don't think well with probabilities. This was famously demonstrated in the Monty Hall problem, named after the host of a 1970s game show "Lets make a deal". The contestant chooses one of three doors. One contains the keys to a car and the other two a picture of a goat. The choice made, Monty opens one of the two other doors, and the rules of the game require him to show you a goat. The question is should the guest switch to the remaining closed door? And why? When this problem was posed in the New York Times they received 10,000 letters insisting that the

wrong answer was right! I mean the mind is not naturally arranged in a way to answer probability based questions. It is not instinctive.

I'll give you another example. One person in a 1000 suffers from a particular disease. Your friend tests positive for the disease with a 99% probability that the test is accurate. What is the chance that your friend has the disease? The answer is one in eleven, but according to surveys that's not what most doctors think! They think your friend is toast! – well the chances are he isn't! It takes just a little thinking through. And this is why they test for dreadful diseases like HIV twice, because the tests aren't that accurate and doctors aren't good at maths! So an inability to think like Zeckhauser and arrange outcomes in probabilities is a considerable error causing bias in investors decision making processes. It is interesting that this was essentially the central message in Rob Rubin's autobiography and Buffett's Chairman's statement this year.

So for example the biggest mistake an investor can make is to sell a stock that goes on to rise ten fold! Its not from owning something into bankruptcy. But that's what everyone thinks, at least judging by the questions we get from clients. Only last week we got questions about our holding in Northwest Airlines rather than the sale of Apple earlier this year. But selling Apple has cost us more. People look at actual costs, not opportunity costs, and what did we say about over-weighing the vivid evidence? And if you understand that, and you understand probabilities, then you'll know Northwest wasn't worth calling us about.

My last psychological hurdle is patience, or the lack thereof. At the beginning of the AGM of the Berkshire Hathaway Company they show this little video and each year Buffett is asked what's the main difference between himself and the average investor, and he answers patience. And there is so little of it about these days. Has anyone heard of getting rich slowly?

What is it Jack Bogle tells us? That the holding period for stocks is down to 10 months and the average mutual fund is held for 2 years? What's that all about? In my opinion quarterly reporting borders on an obsessive compulsive disorder. And how did we get to this state of affairs?

Well I think that the problem is you get two agents – the fund manager, and his immediate client – and they try to eek out some value added in the mind of their clients and it creates these counter productive consequences. You would never get this level of reporting nonsense if it was on a principal to principal basis! And who is to blame? Well I side against the investment institutions. These are largely rich organisations and should behave with integrity, not bow to dysfunctional requests. Behaving like Molly Malone and flashing your knickers at the boys on a Dublin Friday night is not the right way to build a lasting reputation, but that's how these institutions behave.

And it is so unnecessary: we own the only permanent capital in a company's capital structure – everything else in the company, management, assets, board, employees can change but our equity can still be there! Institutional investors have never really reconciled their ability to trade daily with the permanence of equity. I mean are they long term or short term? Zak told me a joke I really enjoyed: two hedge fund

managers meet at a cocktail party and one asks “how are you?” – and the other replies “yeah, I’m up 3% this month”. Good investment process is not apparent in one quarter’s worth of transient stock price quotations, or one year for that matter!

In a small investment partnership that I run we make people sign a form saying they understand that the fund is not suitable for those with time frames less than five years. No one else does that. We make them do it by the way, to try and put the investment in a different psychic space than other savings they may have. And to avoid the pressures of social proof and jealousy/envy I mentioned earlier. Incidentally we have average holding periods well over five years as judged by recent results.

So, patience, social proof, vividness and probability based thinking are the four psychological hurdles I have chosen to highlight and I think we understand these perhaps a little better than the average investor out there…and, I’m not always sure about that. I certainly blew Argentina three years ago, mainly due to over-weighing the vivid evidence - especially the temporary vivid evidence - and that has cost us. I mean, you think you understand this stuff, but you have to keep at it…

But if so, so what? What does all this have to do with our emerging market performance.

Well lets go through some of these psychological misjudgements from an Asian perspective: Well, the Asian emerging markets are Chinese, even in Thailand, Indonesia, the Philippines and Malaysia, which have large indigenous populations, the business elite is Chinese. And the Chinese like to gamble – one of our largest investments is in an old Malaysian casino and its chocked with Malaysian Chinese from KL on a week day, and you should see it at the weekend! - well that does not sound like “patient money” to me. And what have we just learned, that patience matters.

There is very high social cohesion to Asian societies. That is people think alike, and they think literally. This is true in the west, but I think it is probably more true in the east as eastern societies tend not to celebrate the individual to the extent we do in the west. So social proof and herd mentality may be more acute. That is, contrarian thinking seems to be more rare. And at the trough things are very, very cheap.

There may also be a foreign angle to the cheapness too. Most of our competition comes from regional specialists – these people suffer from the same restrictions that tech fund managers suffered in 1999 – they have no where else to go. When they are given funds to manage the covert instruction is to buy growth, not value. The vivid evidence is that Asia is growing – just look at China!

And they have a principal/agent conflict. That’s Zeckhauser’s other pet subject, the principal agent conflict. They have set up offices in every capitol city as if in a marketing exercise to assert local expertise – well its all there on the Bloomberg, at the end of a phone line and in annual accounts. You don’t need local correspondents as well. And you certainly don’t need the drift into group decision making that implies.

So the foreigners in the region typically think like bullish agents, but that is not how the main shareholders think! the families that control Asian companies view is not the institutional agent capitalism we grow up with in the west (and the self promotion that goes with that) – its dynastic, confusion capitalism - that is they think like principals. So in Asia there is this huge dispersion in orientation, between the Chinese gambling mentality of the masses and the tycoons dynastic orientation. The way to bet is not to align yourself with the market patsy, but to think like the tycoons – and our long holding period helps in that regard – back to patience.

In my opinion there is a "false asset class" element to demand for investment product in the region, and this has bred "fake specialisation" in my peers. I mean they know the shape of the economy, but they don't know what a company is worth. Westerners do not invest in Asia to be contrarian! The point is that specialising by geography is not the same thing as specialising in investing.

And we try to specialise in investing. So we don't sell dedicated funds, and we don't go marketing Asian specialisation and when things are unattractive we go looking elsewhere on the planet, and I think that helps. We don't have to be there. Our generalisation by geography and specialisation by discipline is a huge help.

We are trying to be people of good judgement and do intelligent things with money. And so we go to Asia looking for businesses that fit our experience of being in situations that will work, at prices we like. But few people start with that bias. Our peers seem not to be looking at what we are looking at. Like Siam Cement or Jardine Matheson for example, these are huge businesses (JM is the largest private employer in the region, and SCC represented 4% of the Thai economy at one point) and they were priced at sizeable discounts to replacement cost, with better than replacement cost normalised economics, and they have been ten baggers for us. You could not look at Asia and not see these companies. They dominate.

But the point is our performance is better because there is less competition for our shares. Period. And that's because there are less people with our approach. We have found that when we are buying shares our competition is the trade buyer who cannot negotiate 100% of the company at the price at which we can buy a fraction on the stock market. Take a look at Siam City Cement. The day Holderbank bought control of the company, from the family, for Tb170 per share, which equated to replacement cost of the assets – the stock that day close up one baht to Tb48 – less than one third of what the trade buyers were paying. That stock has risen ten fold since.

Well, is this sustainable? Perhaps not, what is it Brian Arthur at the Santa Fe Institute tells us: that people learn and the economy is adaptive. It seems reasonable to expect that over time that advantage will may diminish. As Buffett joked at one AGM – "*the secret to a successful marriage is not looks or money…its low expectations".* And I think that is a healthy starting point when thinking about our emerging market performance.

However, it is true to say that some of the behavioural traits I have mentioned here are as old as the stars and were as valid when Graham wrote the first edition of Security Analysis in 1934 as it is today. Even so, and whilst I recognise that fact, I think it is healthy to think in evolutionary terms and to plan to stay ahead, and we have some

clues to where the leading edge in investment thought is going. Let me read you what Mike Mauboussin at Legg Mason, who is streets ahead, had to say on the subject of decision making:

Slide 5

"*Individuals who achieve the most satisfactory long-term results across various probabilistic fields* (gambling, cards, horses, investing in common stocks, investing in a new plant) *have more in common with one another than they do with participants in their own field."*

Well that just has to be true. Amarillo Slim was the world poker champion in 1972, and his autobiography was published last year into the new poker boom, and is entitled "Amarillo Slim, in a world of fat people" – and if you understand Michael's point, you can see why Slim called his book that. Puggy Pearson was also a world card champion, and he argued that to win you needed to understand the 60/40 end of the bet (when the odds are on your side), know money management (how much to bet), and know yourself. Well that sounds awfully like good investment decision making to me.

Mauboussin again…

"Distinguishing features of probabilistic players include a focus on process versus outcome (I hope I have done some of that today)*, a constant search for favourable odds and an understanding of the role of time*." That is Patience.

It is still amazing to me that everyone assesses a fund manager on his output, not his process. They don't admit that of course. But that's what happens.

"Success in a probabilistic field requires weighing probabilities and outcomes – that is an expected value mindset." Well…think like Zeckhauser.

I'll let Mauboussin have the last word…

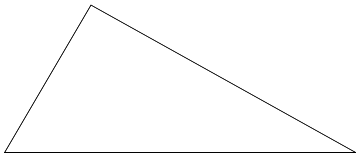
"One key to success is a high degree of awareness of the factors that distort judgement". Well, amen to that.

And now I will take any questions you may have…

Slide 1: Speech Title "So how does Zeckhauser play bridge?"

Slide 2

"Take as an example the aspects of a triangle. This triangle

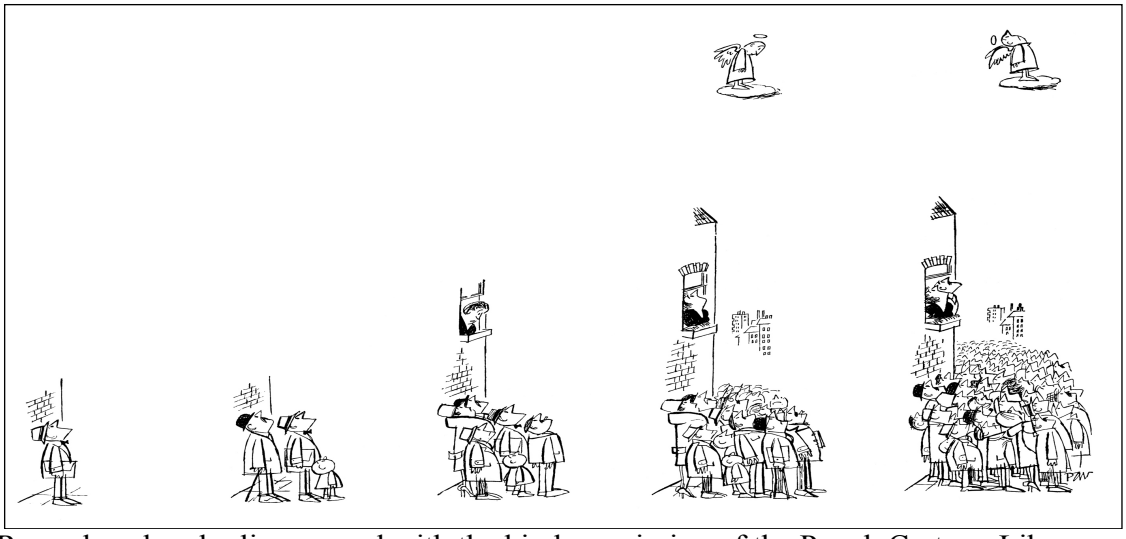


can be seen as a triangular hole, as a solid, as a geometrical d rawing; as standing on it 's base, as hanging from its apex, as a mountain, as a wedge, as an arrow or a pointer, as an overturned object which i s meant to stand on the shorter side of the right angle, as a half parallel - ogram , and as various other things. "

Source: Ludwig Wittgenstein, Philosophical Investigations

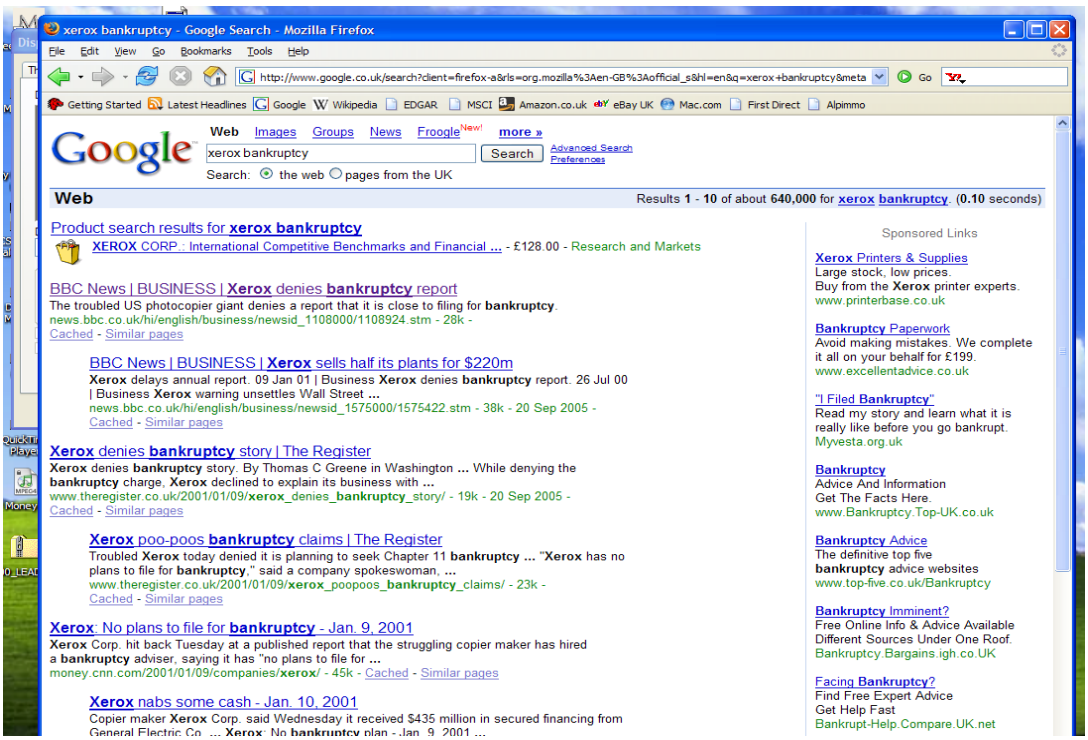
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Slide 3: The Punch Cartoon



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Slide 4



Slide 5

- *"Individuals who achieve the most satisfactory long -term results across various probabilistic fields have more in common with one another than they do with participants in their own field. "*
- *"Distinguishing features of probabilistic players include a focus on process versus outcome, a constant search for favourable odds an d an understanding of the role of time. "*
- *"Success in a probabilistic field requires weighing probabilities and outcomes – that is an expected value mindset. "*
- *"One key to success is a high degree of awareness of the factors that distort judgement ".*

Source: Michael Mauboussin , Legg Mason Funds Management

Slide 6: Final slide, "The right way to think is the way Zeckhauser plays bridge, it's just that simple" Charlie Munger.

Nomad Investment Partnership

Interim Letter
For the period ended June 30th, 2005

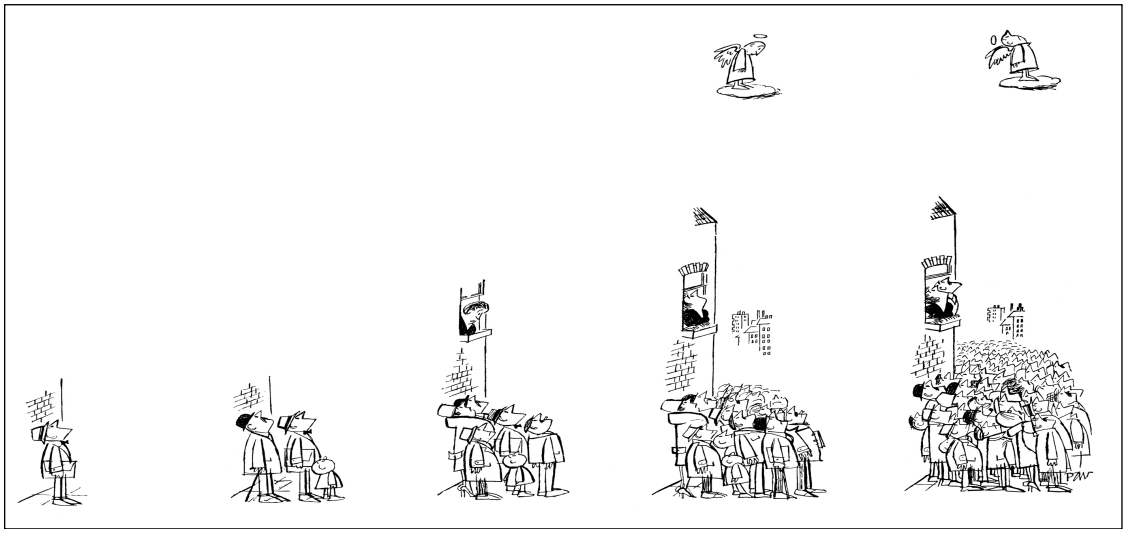
To June 30th, 2005	Nomad Investment Partnership	MSCI All Country World Index (net) US$
6 months	+2.4%	-0.3%
One year	+26.2%	+11.2%
Two years	+78.1%	+38.3%
Three years	+118.7%	+35.4%
Since inception (Sept. 10th 2001)	+150.5%	+28.9%
Annualized since inception		
Before performance fees	+27.1%	+6.9%
After performance fees	+22.6%	+6.9%

The figures above are presented on a cumulative basis (for the "A" shares, after management fees and before performance fees). Below the same results are presented in discrete annual increments. In our opinion, it is the upper table that is most useful in assessing long-term investment performance (see appendix).

To June 30th, 2005:	Nomad Investment Partnership	MSCI All Country World Index (net) US$
6 months	+2.4%	-0.3%
2004	+22.1%	+15.2%
2003	+79.6%	+34.0%
2002	+1.3%	-19.3%
2001 (inception Sept. 10th 2001)	+10.1%	+3.9%

When we said we expect to get rich slowly, we did not quite have the first half of 2005 in mind. Even so, a 2% gain is at least in the right direction and is a little better than the alternatives represented by global stockmarket indices. But more important, the value of the companies in which we have invested rose by more than 2% and we were able to add to some of the cheapest investments with the effect that, by our analysis, the price to value ratio of the Partnership declined from the low seventy cents on the dollar at the end of the year, to the upper sixty cents. A rational analysis would conclude that we are richer twice over, once from the gain in the price of the Partnership to date, and second from the rise in the value of the Partnership compared to its price.

It is a constant feature of the investment landscape that people applaud recent gains when they should be thinking more about the future. We all do this to some extent. We all like rewards and like to be associated with success. And it is hard not to be drawn toward the crowd. One of our favourite cartoons, carried by Punch in the 1970s (and reproduced in the book "Influence: the Psychology of Persuasion" by Robert Cialdini some years later) makes the point.



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Following what everyone else is doing may be hard to resist, but it is also unlikely to be associated with good investment results. Zak and I concentrate on the price to value ratio of the Partnership and ignore its performance as much as is practical, and we would encourage you to do the same. In our opinion you should be more pleased with the improvement in the price to value ratio of the Partnership than the gain in the price of the Partnership this year. That's easy to say when results have been reasonable. But it would feel quite different if the Partnership had declined in price

instead. Unfortunately nature does not always help us to think rationally. Psychologists (McClure, Laibson, Loewenstein and Cohen 2004) have found that the brain perceives immediate rewards differently to deferred rewards because two different parts of the brain are involved. Immediate gains are perceived positively compared to larger deferred gains as the limbic (survival) system has the ability to over-ride the fronto-parietal (analytical) system. Interestingly, stress induces this over-ride, and of course, money induces stress. So, the more stressed we are, the more we value short-term outcomes! This is not without reason, for if starving is a real possibility, a meal today is more important than a feast in a week's time, and the brain's wiring reflects that survival bias. Such notions are embedded in popular phrases such as "a bird in the hand is worth two in the bush". But at Nomad we try to be more analytical: it is the two birds in the bush we are concerned with and how they compare to the bird in the hand. In our opinion, today, the birds in the bush are around 47% (68c/100c) bigger than the bird in the hand. This compares with only around 37% (73c/100c) bigger at the end of last year. The Partnership is up this year, but you can see that it also does not mean very much compared to the deferred gains. It is price to value that's important.

Competitive Advantage

As a young(ish) man there is something slightly depressing about thinking things through for a while, arriving at a somewhat reasoned conclusion only to find that others have been there before, and years earlier. In some respects we are fifty years behind Buffett, but that's ok so long as the average investor is at least fifty-one years behind! I would estimate we were some way behind Bill Miller as well, as evidenced by his recent speech to students of the Columbia Business School in which he posed the question – what is your competitive advantage in investing? It was the elegance of the answer that grabbed us. Broadly Bill Miller argued that there are three competitive advantages in investing: informational (I know a meaningful fact nobody else does); analytical (I have cut up the public information to arrive at a superior conclusion) and psychological (that is to say, behavioural). Sustainable competitive advantages are usually a product of analytical and or psychological factors, and the overwhelming advantage with regard to Nomad is the patience of the investor base and the alignment of that disposition with the analytical and psychological traits of your manager. It simply would not work otherwise. In the investment objective section of the Nomad prospectus we say that our job is to "*pass custody* [of your investment] *over at the right price and to the right people*"…and that "*the approach will require patience*". That's what investing is, at least for us. But let me return to the speech for a moment.

"Think of how the future will be different from the past. Most people default to the directions and trends that they are currently observing…The important thing is that most things change. In longer term projections, Peter Bernstein tells us, that cone of uncertainty gets wider as time goes out. What are the chances that IBM will be bankrupt tomorrow morning? Probably none. A year from now? Five years from now? What about one hundred years from now? The point being that the possibilities increase as time goes out. So what you are trying to do as an investor is exploit the fact that fewer things will happen than can happen. So you are trying to figure out how that probability distribution works and stay in the middle of what will happen. The market has to worry about all the things that can happen."

To repeat: "*what you are trying to do as an investor is exploit the fact that fewer things will happen than can happen*". That is exactly what we are trying to do. We spend a considerable portion of our waking hours thinking about how company behaviour can make the future more predictable, and lower the risk of investment. Costco's obsession with sharing scale benefits with the customer makes that company's future much more predictable and less risky than the average business and that is why it is our largest holding. Our smaller holdings are less predictable but in certain circumstances could do much better as investments. We are just not sure that they will as their "*cone of uncertainty*" has a much greater radius than at Costco. Bill Miller got there years ago. We are just getting there today.

The Robustness Ratio

At the risk of mildly boring some readers, it may be worth completing the analysis of Costco here by introducing the robustness ratio. (Avid readers will recognise that this ratio was introduced in a Global Investment Review, contained in the appendix to this letter). The robustness ratio is a framework we use to help think about the size of the moat around a company. It is the amount of money a customer saves compared to the amount earned by shareholders. This ratio is more appropriate for some companies than others, the prime criteria being that the customer proposition is based on price, such as exists at Costco, as opposed to an advertising-reinforced purchase such as Nike trainers. In the Berkshire Hathaway annual report this year, the Chairman tells us that Geico policyholders saved U$1bn on their policies compared to the next cheapest carrier. It also turns out that Geico earned around U$1bn as well. So that's one dollar saving to the customers and one dollar retained for shareholders. At Costco we think the customer saving is around five-dollars, compared to shopping at most supermarkets, for every dollar retained by the company.

So what? Well, it is probably fair to argue that the higher the ratio, the harder it would be to compete against Costco on a like for like basis. Also, a higher ratio may imply a somewhat inequitable distribution of system rewards between customer and shareholder than a lower ratio. There is a tension here between the size of the moat on the one hand and the distribution of rewards on the other. In the last few years the pendulum has swung in favour of the customer, with the result that the stock is cheap enough to be vulnerable to a leveraged buy out (completely unobserved by Wall Street where only one in five analysts rate the stock a buy, which solves for the shares being cheap enough to fund a buy out in the first place – the two are of course linked). This is a huge source of risk for current shareholders since being taken out at a low price amounts to theft. It's that serious, and you can rely upon us to see it that way. We think the board understands this, and the way to bet is that the pendulum will swing back in favour of the shareholders over the next few years. Look around you. How many companies save five dollars for their customers for every one dollar they keep?

It does not happen in the investment industry were fees can be levied regardless of performance – that's not much of a robustness ratio and does not take into account the asymmetry of the risks involved. You can't lose money shopping at Costco, but you can investing. This would argue that robustness ratios needs to be much higher in the investment industry than for normal businesses to compensate for the risks involved. We have tried to some extent to account for this asymmetry through Nomad's six

percent performance hurdle. It is not perfect, there is no science behind the number, although it is meant to represent a generous proxy for deposit rates. And besides having a hurdle rate helps us sleep at night.

Zimbabwe as an Example of a Second Investment Model.

We have begun making some investments in Zimbabwe and wrote about the background to these in a recent Global Investment Review (also contained in the appendix). The investment case relies upon extreme undervaluation compared to normalised values, so much so that a wait of ten years for normalisation would still yield wonderful results. It makes little sense to discuss stocks we may or are buying (Costco is likely to be a rare exception in this regard) but I can illustrate the investment case by describing Zimcem. This is the country's largest cement producer (after the local division of Pretoria Portland Cement), with around 700,000 tons of cement capacity and a replacement cost of around U$70 to U$100m. The firm has no debt and business conditions are awful (general inflation exceeds cement price inflation and product demand is low) but the company is priced on the Harare stock exchange at one seventieth (1/70th!) of its replacement cost.

Why is this relevant? So far we have only discussed one model we use to pick good investments which we call "*scale efficiencies shared*" as evidenced by Costco (and to a lesser extent Amazon.com). We have little more than a handful of distinct investment models, which overlap to some extent, and Zimcem is a good example of a second model namely, "*deep discount to replacement cost with latent pricing power*". Indeed these two models combined can be used to describe around 45% of total Partnership assets. It was this model that led to many investments during the Asian crisis (such as Siam Cement which has risen twenty fold from the trough in eight years) and to neighbouring South Africa where Pretoria Portland Cement could be bought at a price of U$20 per ton of capacity in 1998 and is now valued at U$180 per ton. The model is premised upon the observation that the business needs to replace its assets and will require prices which 1. fund the capex, and 2. economically justify the spending. Either that or Zimbabwe will have to go without cement, or import from abroad (tricky for this land locked country). In any event, provided discretionary capital is not invested to exacerbate the situation, the supply side remains muted (industry capex is zero) and the business is not nationalised, then the shares ought to do well, in time.

This last point, along with other confiscation events, does not have a zero probability, and is the main reason our investments in the country will be modest in size. Even if we were able to secure all the shares we desire (which we seem incapable of doing) it is unlikely that the total investment would be much more than a few percent of the Partnership at cost. There is no a priori reason why Zimbabwean businesses should not trade at a premium to replacement cost. Just over the northern border Zambia's dominant cement company is now valued at a premium to replacement cost following recovery in the economy after years of mismanagement. In Zimbabwe this may require "*regime change*", or even regime changes. Perhaps the investment case rests in your manager being fifty years younger than Bob Mugabe.

The Pricing of Shares in Zimbabwe

The official exchange rate at the time of writing is Z$9,100 to the U$1. The unofficial, street rate is around Z$17,000 to the U$1. In other words the Central Bank values its own currency at over twice the price set by the public with the effect that money entering the country via the Central Bank buys approximately half as much as at the street rate. Fortunately there is an alternative to the Central Bank for foreign investors, which is to purchase Old Mutual shares in Johannesburg, re-register the same shares in Harare and then sell the shares in Harare. This we have done. But it creates a problem in valuing our Zimbabwean shares as Bloomberg, Reuters and the other main sources of currency prices use feeds from the Central Bank. In other words if we solely relied upon the official rate of exchange our investments would immediately show an 86% gain. This gain is entirely illusory. Were we to reverse the process by re-registering the shares in Johannesburg and selling our stock there, the proceeds would approximate the money we first put in (minus frictional costs and any change in the price of Old Mutual shares). The only way we could realise the 86% gain would be to present our Zim dollars to the Central Bank and ask for US dollars at a rate of Z$9,100. And we would be waiting for Godot. There are almost no transactions taking place at the Central Bank and priority is given to trade and working capital requirements, not foreign investment portfolios. So we could try, but I don't think it is prudent to value the portfolio on the basis of a warm response from the Zimbabwean Central Bank. So our solution has been to value the Zimbabwean investments at the rate of exchange implied by the Old Mutual share price in Harare divided by the price of exactly the same share in Johannesburg (note that the shares are fungible in both directions). The effect is to approximate the street rate of exchange and remove the artificial book gain implied by the official exchange rate, and hopefully the worst of any pricing distortions should be minimised as a result. This is a somewhat unusual solution, but one that I think is fair, and the auditors, board and administrators have decided to agree with my methodology. Please do call however, if all is not clear.

"*Any year that you don't destroy one of your best loved ideas is probably a wasted year*", Charles T. Munger.

In January this year, the market town of Carlisle (located between the English Lake District and the border with Scotland and incidentally home to your manager's family-in-law) was flooded when the River Eden broke its banks. Parts of the city centre were under many feet of water and residents were shown on national TV being evacuated from roof tops by helicopter. As the water receded the city slowly returned to normal, although the damage remained extensive, and included the traffic light system at Hardwicke Circus, a junction of seven roads controlled by a series of traffic lights dotted throughout approaching roads and a central roundabout. Although the lights remained out of use, the authorities opened the roads and trusted the residents to drive with care. Soon afterwards, drivers began to suspect that the traffic flowed better through the complex junction without the traffic lights than before, and in March this year the City Council began a trial in which the lights were covered up, and drivers left to get on with it. What they found confirmed public suspicions, the speed of traffic through the intersection had indeed risen, and better still, it appeared that the number of accidents may actually have fallen as well. What they found was entirely contrary to accepted wisdom in council planning, that the roundabout was faster and may also be safer without the traffic lights! Ayn Rand would recognise what was

happening, as may members of the Santa Fe Institute (which recently published a study entitled "*How Individuals Learn to Take Turns: Emergence of Alternating Cooperation in a Congestion Game and the Prisoner's Dilemma*"). The point is that, often, if one removes the rules, and instead ask people to think for themselves, the system works better.

We criticise hedge funds for their fee scales and short investment time frames, but they have a point when it comes to investment rules and certain regulations. Traditional investment management can become heavily burdened by bureaucracy, compliance and corrupted by marketing expediency. These business forces can work at the expense of the investment process, and the trick for any growing investment firm is not to sap the life out of the investment team through stapling them to the bureaucratic equivalent of the US Department of Agriculture. We think of ourselves as reasonably entrepreneurial, but even we suffer to some extent from this culture drift. The solution is not hard to come by. What is required is for people to behave in such a way that, in the words of Charlie Munger, one builds "*a seamless web of deserved trust*". The operative word is "*deserved*". The problem is that rules do not require people to think, and how are people to deserve trust if first they don't think? Degenerative spirals of behaviour do not build good results (or fast roundabouts), but that is where the industry is going, and it is a destination we will all do well to avoid.

We try not to be too hard and fast about rules. In previous letters we have quoted H.O. Hirt, founder of Erie Indemnity, and it would be a shame not to do so again. Hirt posted the following notice to staff:

"*RULES*
*Are for INFANTS**, INCOMPETENTS,***
INCARCERATED CRIMINALS** and **IMBECILES
***- NONE** of WHOM should have any place in*
*the **ERIE FAMILY**."*

Even so a few rules end up slipping in over time and need to be viewed with great suspicion. One was that a low share price was better than a high share price, all other things being equal, which proved unwise when the low market capitalisation undermined shareholders' bargaining position in the recapitalisation of Conseco a few years ago. This year we shall have to discard another strongly held bias which is that high inside ownership is a good thing. This too is not always helpful, as shareholders in Northwest Airlines are finding out. In this instance the unions appear to reason that management (who are the largest group of shareholders) will not risk placing the company in bankruptcy and are holding out for the last dollar in negotiations. Oddly here, high inside ownership is hindering the process that would lead to a more viable airline. Who would have thought that a low share price and high inside ownership could be bearish? But they can. I wonder what other "*best loved ideas*" we will need to rethink in the coming years.

Thank you

We don't write to you that often, as measured by number of letters per annum. But the sum of the letters we write amounts to around ten per stock holding period (two annual letters times five years). On this measure we may be more communicative than

many investors who write more often, but trade shares more frequently still. Even so, we like the balance as it is, and are hesitant to fall into say-something territory. We are very conscious that investors in the Partnership have reciprocated and allowed us to get on with our job of roaming the globe looking for value. Thank you.

To date we have appended a copy of the schedule of investments with our letters. This is not necessarily in Partners'· interests. There are powerful psychological reasons for not doing so associated with commitment and consistency tendency (covered in previous letters), and then there is the issue of others piggy-backing on ideas. This is not so much a problem today as few care what we do and the Partnership is small, but it could become an issue should the Partnership grow. Only the other week I received a request from a London based hedge fund (with a reputation for short term punts) for another copy of our Global Investment Review. Think of that! We did not know they had one copy, and they were casually asking for another? What are they going to do with the information? If Partners wish to circulate our schedule of investments to others, then they must understand that their actions are contrary to their (and our) economic interests in Nomad. The same cannot be said for those that are not invested. So, if you are a Partner then you will find a copy of the schedule of investments attached to this letter, and we ask you to use that information wisely.

On the administration side, please do call Daiwa Securities Trust and Banking in Dublin with your enquiries (+353 1603 9921). The 2004 Nomad annual report and accounts were mailed to shareholders in May, considerably earlier than last year. I am also aware that there have been issues with the timely receipt of statements. We are on to it, and nag Daiwa constantly. Please do press them if you are not fully satisfied. They are here to help you, and you have paid for their services. Don't be shy, we aren't. Likewise, Alexandra Aitken at this office (+44 207 497 2211) is employed to help Partners with basic performance and statement enquiries.

As always it is a tonic running this Partnership. We value your confidence in us very highly and thank you for your patience.

…back to the company annual reports.

Yours sincerely

Nicholas Sleep

· In this article, we use the term "Partners" as a generic term referring to all Nomad investors, whether shareholders in the feeder fund or limited partners in the Partnership and not, in the strict, legal sense of the word, to imply the creation of a partnership between shareholders in the feeder fund, Nomad and/or Marathon Asset Management.

Appendix

"Measuring the Moat". Global Investment Review, May 2005.

The phrase "business moat" is often banded around when discussing the absolute or comparative strength of a franchise. That there are businesses with defendable positions is of little doubt; but what these discussions often lack is any empirical method by which moat size or longevity can be measured, compared or monitored over time. In addition stock investors (particularly those who, for their sins, have been labelled growth investors) face an important task, namely, how can one recognise the creation of a business moat well in advance of its value being discounted in the stock market? While reading the 2005 Berkshire Hathaway Annual Report, one paragraph stood out for us as Warren Buffett referred in passing to the division of operating and underwriting cost savings at motor insurer GEICO. These "benefits" were divided between shareholders, policy holders and employees and the statistics spelt out in some detail. This simple breakdown struck a chord with our continuing analysis of Costco, a significant Marathon shareholding in the United States. What is becoming clearer in our minds is that one can empirically measure the strength of a business franchise through such an analysis of the division of benefits, what we have come to call its "robustness ratio".

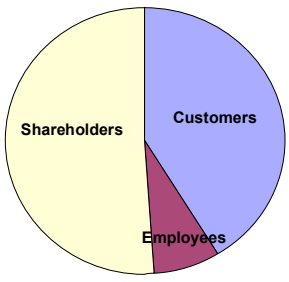
First, a brief recap of Buffett's comments with respect to GEICO.

> *"Indeed, GEICO delivers all of its constituents major benefits: In 2004 its customers saved $1 billion or so compared to what they would otherwise have paid for coverage, its associates earned a $191 million profit-sharing bonus that averaged 24.3% of salary, and its owner – that's us – enjoyed excellent financial returns."*

Source: Berkshire Hathaway, 2005 Annual Report

These financial returns, measured in terms of an underwriting profit, were close to US$1 billion pre-tax last year but this excludes the investment returns earned on the US$5-6 billion of float generated by GEICO throughout the year (on which we may want to assign subjectively a return of 5%). These benefits, of course, only accrue to the three groups as a result of scale (if one assumes that underwriting skill can be developed or acquired). This allows us to construct a pie chart (Figure 1) representing how these scale economies are shared. The robustness ratio, defined as the combined distribution to customers and employees (through a profit share or the like) divided by the distribution to shareholders, is in GEICO's case about 1:1.

Figure 1: GEICO: A fair division of spoils

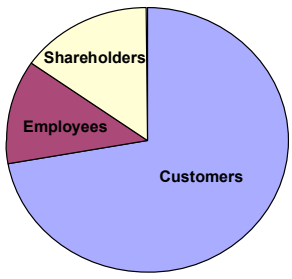


Source: Marathon

This picture, of course, represents a snapshot; just as important is how this division of benefits develops over time, a subject we will touch on later. Tracking back to Costco, we are able to construct a similar pie chart using the following facts and figures. On average, a Costco cardholder (as opposed to household; on average each household holds 2 cards) spends US$1,100 per year in the store. Costco spends US$980 at cost to supply these goods which, if one assumes similar buying power and a comparable basket make up, would cost US$1,300 at a competing supermarket such as Kroger or US$1,250 at Wal-Mart (gross margins of 26% and 23% respectively, compared with 11% at Costco). Now these comparisons are not quite so straightforward as Costco's members must "pay to play", currently US$23 per cardholder on average, and this annual fee is fixed whatever a cardholder spends (this implies the distribution of customer savings is not even across the membership base, a fascinating influence on customer behaviour and itself worthy of analysis). But we can estimate that, on average, a Costco cardholder saves somewhere in the region of US$175 per year by shopping at Costco in return for an annual fee investment of US$23, or a net gain in the region of US$150 per cardholder per year.

Now we turn to employees. From recent management meetings, we have gained some clarity on the difference between Costco's wage/benefit scales and those available from competitors (this difference being the functional equivalent of GEICO's profit related bonus). If we assume that 70% of Costco's SG&A is made up of wages/benefits and that Costco's wage/benefit scales are 55% higher than the competition, then Costco, in a sense, "overpays" its employees to the tune of US$1.1bn per year, or US$26 per cardholder per year. Finally, shareholders. On Wall Street, there has been a suspicion that the return to shareholders has been a "residual" after customers and employees have been well cared for. And at US$32 per cardholder pre-tax, or 15% of the distributable pie, the shareholders' share is not in the same league as at GEICO. In any case, Costco's pie chart (Figure 2) looks something like this and its robustness ratio is of the order of 5:1.

Figure 2: Happiness is… being a Costco customer.



Source: Marathon

While the standard Wall Street view is that such a picture is retailing's equivalent of collectivism, in our view it represents an excitingly wide and unassailable moat. While "unassailable" may seem like a bold assertion, an analysis of the limited disclosure of financials at Sam's Club suggests that the size of the distribution to Costco customers is so large that any attempt to match its prices would cost Sam's somewhere in the region of US$1.4 billion annually while matching Costco's pay scales would set them back another US$750 million. Such numbers are not insignificant even to Wal-Mart which last year earned net profits of US$9 billion.

Such a chasm of competitiveness is, of course, difficult to capture using traditional analytical tools. After all, both Costco and Sam's Club generate thin profit margins, both are growing revenues and both are placing enormous pressure on traditional supermarkets and smaller wholesale clubs. But it seems inevitable that the long-term outcome for the two businesses will be significantly different particularly as measured by the growth of *revenue per unit of selling space* over the long-term. And Costco's business model dictates that this competitive gap should expand over time as a fall in Costco's relative asset intensity and increasing buying power will lead to greater scale efficiencies, which in turn are handed back to the customer in the form of lower prices. Game over.

Having come to such a robust conclusion we should offer a word of warning. Both Costco and GEICO have strong corporate cultures, embedded in which is the inspirational thought that the rational (and equitable?) division of benefits is the only appropriate way of ensuring these businesses will *grow* in strength as they grow in size. And while culture slippage at GEICO is hard to envisage, courtesy of its place in the Berkshire Hathaway corporate museum, the same may not be true of Costco. An unpleasant output of this apparent disregard for shareholder returns is that the Costco share price is broadly unchanged on levels reached six years ago. And Wall Street is, by all accounts, not happy. Even a culture built up over forty years is not immune to this pressure and Costco's senior management team are beginning to feel the heat. Indications are that the company is gently tinkering with the division of benefits in favour of shareholders in part to satisfy the quarterly EPS junkies but also in recognition that an asset-rich Costco represents an attractive target for private equity buyers. Long-term shareholders should view such slippage as worrying and unnecessary. In our view, the correct response to a six-year share price famine is for the company to use its balance sheet to buy back shares at prevailing prices and allow the long-term growth in free cash flow per share (an inescapable function of steady margins, falling asset intensity, growing revenues and a shrinking base of shares outstanding) to translate into a higher share price over time. The argument for allowing the robustness ratio to drift gently ignores the impact on future generations of managers who will have been presented with a precedent for tweaking the model when expedient. We do not presume to lecture the remarkable managers at Costco on what the appropriate robustness ratio should be, just that any changes to the division of benefits should be made for purely competitive reasons and not driven by a wish to pander to investors.

We wouldn't wish readers to come away with the view that robustness ratios are a numerical magic bullet to measure moats. They are plainly not. There are numerous reasons why Costco's 5:1 and GEICO's 1:1 ratios may be equally powerful barriers to competition and why a ratio even finer than that at GEICO may be perfectly sufficient to repel competitive marauders. Also, falling ratios are not necessarily a sign of shrinking moats, just that moats are not being made as wide as they could be. Where robustness comes into its own is in identifying companies, such as Costco, which may be under-earning when compared to their potential. This generates super long-term investment opportunities for those willing to look beyond reported earnings.

Early in a firm's development it makes sense to reward customers disproportionately as customer referrals and repeat business are so essential to the development of a valuable franchise. With maturity this bias can be reduced and shareholders can

reasonably take a greater slice of the pie. Too much, however, and the moat is drained with negative consequences for longevity. The temptations are enormous because capital markets will reward profiteering. There are many examples of companies which “harvest” excessively, when perhaps they should focus on longevity. This may have been what happened at Coca Cola which has leant excessively on bottlers, or Gillette where advertising has been cut, or even at Home Depot which has boosted gross margins in recent years. Shareholders often suffer a double whammy as highly rated companies enter “growth purgatory”, because growth slows just at the time when shareholders spot their misanalysis of reported profitability.

Appendix

"Zimbabwe". Global Investment Review, February 2005.

"That's what brothers are for, brother."

Gil Scott-Heron, "Small Talk at 125th and Lenox".

Some commentators believe that the current condition of stock markets is now more dangerous than the bubble of the late 1990s. Then at least there was the anti-bubble formed from cheap low growth companies. Today there is no Zen-like symmetry to stock prices; and there are few obvious pockets of undervaluation for the contrarian. A cheer all round then for Zimbabwe. The clients will hate it. Compliance will hate it. The consultants will hate it. Marketing will hate it. The size of the investment opportunity is tiny. It is not part of the benchmark. It is not even part of the Commonwealth. It's perfect.

Not that it is exactly risk free. Not "risky" in a tracking error, index relative, transient stock price quotation, quarterly reporting sense. The real risk comes in the form of a sleepy, quick to smile, want to get on with people apathy that pervades the population. The financial pages of Harare's Daily Mirror newspaper continue to publish the exchange rates for the deutschmark, French franc, Spanish peseta and Italian lira. Presumably it is someone's daily task to take one number and multiply it by another for the purpose of completing the next day's currency table. No one has noticed that the currencies no longer exist. This is not a good precedent for reform. Neither was the paper's headline which read – "Officials Grab Cell Phone Lines". First, there is the physical impossibility of the act; one could in theory grab a land line, but a wireless phone line? Secondly the problem is few people in Zimbabwe appear politically active, let alone angry. The editorial was not angry. And if no one is angry then what is the prospect of the Meikles Hotel occupancy exceeding its current 30%, except during the occasional English cricket team tour, which was controversial in England but locally ignored.

The most valuable company in the country as measured by the price of traded shares at the stock exchange is worth U$150m at the official exchange rate, and U$100m at the unofficial. That is less than one tenth of the quarterly dividend payment from the ExxonMobil Corporation. The price earnings ratio of the index constituent stocks is less than three. Most industrial concerns are valued at less than the replacement cost of their assets, not that anyone is replacing assets. And that's bullish. The ungeared Lafarge cement subsidiary has a market capitalisation of U$2.5m. There is some difficulty precisely assessing the size of plant capacity but bearing in mind that replacement cost for a cement plant is around US$120m per tonne, we don't need to be too accurate.

Zimbabwe is not a good advert for black capitalism. But it is not a good advert for white capitalism either. The occupation of white-owned farms looks racially motivated, but note that it has been followed with the intimidation of black bankers as well. Zimbabwe can be described as a fascist state, in denial. Not only is not encouraging, but it is also not sustainable. Destroying the agricultural sector because it is white-controlled is stupid to the point of evil, when agriculture makes up 65% of

the economy. It's the poor blacks that will be affected the most. The closest parallel may be that of Indonesia where the minority Chinese population control a large share of the economy. That is not necessarily a disproportionate share of the economy, as one likes to think they earned it. But the point is that the majority resent the rich minority, black or white, and the politicians feed on the distrust when their own policies have failed.

But unlike Indonesia, there was no boom to precede the bust. Zimbabwe has never been a tiger economy. This bust is political not economic. It is not predicated upon over-investment, over-borrowing or over-enthusiasm. But that means there is almost no bad debt in the economy. A visit to the publically listed Barclays Zimbabwe revealed bad debts at 4% of the loan book. So there is no recapitalisation needed here, no Argentinean default situation. One reason is that the dispossessed white farmers have repaid their mortgages and working capital loans in order to take title to their land. In most cases their farms have not been compulsorily purchased by the government, although the government has tried. Most farms have been occupied by mobs whose interest has been to loot, not produce. One farmer we spoke to had been given twenty-four hours to collect his belongings and arrange his affairs before occupation. The looters then looted, taking the 2,000 head of cattle to market in the nearby villages and apparently feasting on the cattle not sold. Yet the agricultural equipment was left untouched. There is no market for the kit with few productive outlets for its use domestically, and so it is left idle, waiting for its owner's return. In the meantime the farm lies fallow, the equipment sits in storage, the economy is denied its exports and the currency spirals downward to reflect the country's new worth. When and if the regime changes some farmers will return, armed with their title certificates and reclaim their property – just as the Chinese have in Indonesia, and the West Germans in East Germany. Meikles Financial Services, a retail credit operation, claim bad debts of just 1% of receivables. Their loan book is lent to those that are staying in Zimbabwe. With debts this low, the economy could recover quickly when confidence returns. But what is to be done about the apathy?

In the early 1970s the black American poet and musician Gil Scott-Heron was an angry man. Unlike his fellow activists he was not just angry at the white establishment, he was also angry at the insincerity of his fellow black men: especially "those that hung out on street corners in Harlem with a 'blacker-than-thou' attitude" who felt that everyone-else owed them a living. This is the attitude of the political class in Zimbabwe. These are Ayn Rand's "looters". In contrast to some of his fellow activists, Scott-Heron wanted his black peers to have integrity, be sincere, and be capitalists. Zimbabwe could do with a few Scott-Herons right now. Perhaps the lyrics to Scott-Heron's song "Brother" could be slipped into Robert Mugabe's suggestion box.

"We deal in too many externals, brother
Always afros, handshakes and dashikis
Never can a man build a working structure for black capitalism,
Always does the man rebound off a known.
I think I know you would-be black revolutionaries too well
Standing on a box, on the corner, talking about blowing the white boy away,
But that's not where it is at yet, brother.

...You need to get your memory banks organised, brother
Show that man you call an Uncle Tom just where he is wrong
Show that woman you are a sincere black man
All we need to do is see you shut up, and be black
Help that woman!
Help that man!
That's what brothers are for, brother."

Nomad Investment Partnership

Annual Letter
For the period ended December 31st, 2004

To December 31st, 2004	Nomad Investment Partnership	MSCI All Country World Index (net) US$
6 months	+23.2%	+11.5%
One year	+22.0%	+15.2%
Two years	+119.2%	+54.4%
Three years	+122.1%	+22.6%
Since inception (10/09/01)	+144.6%	+29.4%
Annualized since inception		
Before performance fees	+30.8%	+8.0%
After performance fees	+25.7%	+8.0%

The figures above are presented on a cumulative basis (for the "A" shares, after management fees and before performance fees). Below the same results are presented in discrete annual increments. It is the upper table that is most useful in assessing long-term investment performance (see appendix):

To December 31st, 2004:	Nomad Investment Partnership	MSCI All Country World Index (net) US$
2004	+22.0%	+15.2%
2003	79.6%	+34.0%
2002	+1.3%	-19.3%
2001 (inception 10/09/01)	+10.1%	+3.9%

2005 is the fifth calendar year of the Partnership. This is important only in as much as we asked you to measure our performance over rolling five year periods and we are now in the final stretch to our first five year anniversary. Since inception we have turned a dollar into two dollars and forty-four cents before performance fees, and two dollars and fourteen cents after fees, compared to an index that would have added around twenty-nine cents to the original dollar. But there is some way to go yet, and as always, please, no mental extrapolation of historic performance, that is simply a recipe for everyone to get upset.

There has been much comment in the press of the recent success of so called "value investors". In general the commentary has described the last few years as suiting "value investors", just as the last few years of the previous decade are described as suiting "growth investors". We will discuss growth and value some more in this letter. Certainly it is fair to say that our results indicate they have been fruitful for contrarian investors. But now with prices higher it is a little harder. A word of warning: the current market is not like the end of the 1990s when a bubble in high priced mainly technology stocks was balanced with Zen like symmetry by an anti-bubble of cheap, slower growth business. Today, prices are evenly high across the various opportunity sets, and there are few readily apparent pockets of under-valuation of size. We particularly enjoyed an editorial in the Investor's Business Daily carried in December, which captures the mood of the markets quite well,

"The Fed tightens, stocks go up.
The dollar falls, stocks go up.
Oil soars, stocks go up.
Retail sales wobble, stocks go up.
Is this a great country or what?"

It is probably fair to say that reinvestment risk (the risk from investing the incremental dollar poorly) is probably higher today than normal. But then, with the Partnership closed, we do not have many incremental dollars to reinvest.

Growth and Value

The debate over growth and value is perennial, and quite unnecessary. Warren Buffett got it right years ago:

"Whether appropriate or not, the term "value investing" is widely used. Typically, it connotes the purchase of stocks having attributes such as a low ratio of price to book value, a low price-earnings ratio, or a high dividend yield. Unfortunately, such characteristics, even if they appear in combination, are far from determinative as to whether an investor is indeed buying something for what it is worth and is therefore truly operating on the principle of obtaining value in his investments. Correspondingly, opposite characteristics – a high ratio of price to book value, a high price-earnings ratio, a low dividend yield – are in no way inconsistent with a "value" purchase."

Source: Berkshire Hathaway 1992 Annual Report.

We won't end the debate here but, so that we all understand, our definition is that a business is worth the free cash flow that it can be expected to generate between now and judgment day, discounted back at a reasonable rate. Period. Growth is therefore inherently part of the value judgment, not a separate discipline. If it is that simple, and it is, (at least, the definition is simple) then how has the industry got in such a muddle, and why do commentators continue to use price to book ratios, price to earnings ratios or their modern equivalents such as EV to Ebitda, as a proxy for value. We all know that it does not mean a thing. So why do we do it?

Psychologists refer to simple rules of thumb as heuristics. In normal life heuristics generally work. We do not consciously process all the possible combinations of clothes in our wardrobe when dressing in the morning, instead we subconsciously use heuristics to narrow the options. However, in the stock market, doing half the work (only observing a portion of the wardrobe) is of limited benefit if successful investment requires more work. Price to book, price to cash flow etc, cannot be an accurate substitute for the definition we provided above. The wide use of valuation heuristics in the industry is quite bizarre. Their informational value, leaving aside inaccuracy for a moment, can be limited if only because successful investing is a minority sport. Their survival can probably be attributed to intellectual laziness on the part of the investment professional, and spin on the part of the industry's marketing departments. It certainly has little to do with investment excellence. So when commentators suggest that "value" has beaten "growth", or "growth" has beaten "value", please note that little of real substance is being imparted. It certainly has little to do with our Partnership's results.

Why we think what we think

It is only in such a topsy-turvy world that a common sense Investment Partnership, such as Nomad, can be seen as lunatic fringe – trust me, we are. The industry has a dreadful time pigeon-holing our Partnership. Not that we mind one jot. Nomad is a value investor in the sense that we like to buy stocks at half price. But the largest holdings would be described by most of our peers as growth stocks. We have the ability to invest globally, but 40% of Partnership assets are in South East Asia. We are concentrated (the top ten holdings make up around 65% of Partnership assets), but we have investments as small as 0.5% of assets. This year we held company meetings in California, Johannesburg and Hong Kong, where we have investments, but also in Zimbabwe, where we have none, just because we were curious. We asked the London office of Rio Tinto plc., a large global mining business, if they could help arrange a meeting with their Zimbabwe subsidiary quoted on the Harare Stock Exchange, only for their investor relations officer to ask "*is it listed?*"! We can own listed and unlisted equity and bonds, like a hedge fund, but we can't go short. We have a performance fee that is equitable, not egregious, in an era when egregious is the norm. It is so equitable that a famed US investor told us "*you won't make money like that*", meaning the management fee is too low. But we have made money, we have earned it through performance, not asset gathering. But most important of all, we do not resort to "belief" statements to justify our actions (look out for the use of that particular word when discussing investments, particularly when "belief" is attached to a heuristic). Ayn Rand had it about right when she wrote John Galt's famous speech in Atlas Shrugged that *"no substitute can do your thinking"*. Watch out, this industry is full of the non-thought of received ideas, starting with the value, growth debate and

valuation heuristics. We think we try harder than most to be rational and creative. The combination of the two is important. It is nearly seventy years since John Maynard Keynes wrote his "General Theory". Surprisingly little has changed:

"Finally it is the long term investor, he who most promotes the public interest, who will in practice come in for the most criticism, wherever investment funds are managed by committees or boards or banks. For it is in the essence of his behavior that he should be eccentric, unconventional and rash in the eyes of average opinion. If he is successful, that will only confirm the general belief in his rashness; and if in the short run he is unsuccessful, which is very likely, he will not receive much mercy. Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally."

Source: The General Theory of Employment, Interest and Money
John Maynard Keynes.

Why is no one doing a good job?

Among the best performing stocks of the 1990s were EMC, Dell, PMC Sierra and Microsoft. These were the cheapest stocks a decade ago, but no value investor owned them. But then again, none of the large growth investors (excluding insiders) owned the shares all the way through the decade either. Why is this? Why weren't value investors, those who claim to be good at pricing a business, invested in Dell in 1990? Why is no one doing a really good job?

No, we weren't invested in Dell either. Worse still, we weren't looking. Although Dell was not expensive at the time, I am sure we would have concluded that its probability of failure over the next decade would have been high, or at least high enough to stop us owning the shares. A study by Michael Goldstein at Empirical Research, a research boutique, claims that the probability of growth stock failure (company growth slowing) is as high as four in five over five years and nine out of ten over ten years. And in the case of Dell we would have been wrong. We take no comfort from the fact that not seeing success is a perennial investment mistake: in the 1950s a large Baltimore based fund management company sold their clients' shares in IBM only for the shares to appreciate to the point that the value of the shares sold would become bigger than the whole fund management company itself. What we are trying to do today is avoid the Baltimore company's second mistake, which was to sell an equally big stake in Wal-Mart in the 1970s!

When investors describe themselves as growth or value it might be helpful to have two questions in mind. To the value investor ask, "what is it about your approach that would have stopped you owning K-Mart for much of the last twenty years?" (K-Mart was a "cheap" stock, as measured by say price to book value – but a dreadful investment, recent performance notwithstanding), and to the growth investor ask "what is it about your approach that would have stopped you selling Wal-Mart?". So how does one avoid these mistakes? The answer lies in analyzing not the effects and outputs of a business, but digging down to the underlying reality of the company, the engine of its success. That is, one must see an investment not as a static balance sheet but as an evolving, compounding machine.

Deconstructing the Business case for Costco Wholesale

We have written about Costco before (December 2002) but make no apologies for its inclusion again. The reason is that it is important to us that you understand not only what we do, but why we do what we do. This is not easily done, as I am sure I will now demonstrate. In our experience very few investors understand what their managers really do. We know this because fund managers are often sacked at the trough of their relative performance, and invariably just as performance is about to turn. Clients that sacked Marathon at the end of 1999 (you know who you are) have missed out on a 12% annual gain compared to the index since, a gain which far outstrips any deficit against the benchmark during previous years. So education is important. It helps both parties make rational decisions. Costco is also an important investment for the Partnership at close to 10% of assets. I am also conscious that in the September issue of the Global Investment Review, your manager wrote an article explaining the risks of doing precisely what he is about to do. That is, by publicly committing to an investment it may become harder subsequently to change one's mind. A copy of the essay is contained in the appendix. However, on the basis that fore-warned is fore-armed, I shall continue. You will understand if we don't sell our shares just yet!

Costco Wholesale is a member-only wholesaler of consumer goods. Membership is available to the public at a price of U$45 per annum. The act of purchasing membership has the effect of raising the company's share of mind with the customer in the same way that consumer goods companies hope to achieve with conventional advertising. At Costco, the consumer has chosen to commit to the retailer. In other words people shop at Costco because it is Costco, not because Costco stocks Coke. And the reason they shop is that goods are priced at a fixed maximum 14% mark up over cost. The fixed mark up is referred to in the industry as "every-day-low-pricing" or EDLP, in order to differentiate it from normal industry practice of changing prices in an attempt to influence traffic, or so called high-low pricing. At Costco the consumer pays no more than 14% over what the company paid, period. In the December 2002 letter to shareholders we wrote:

"To understand how important EDLP is to Jim Sinegal, the firm's founder, consider the following story which was recounted to us by a company director. Costco bought 2m designer jeans from an exporter and shipped them into international waters and re-imported the jeans for an all in price of U$22 or so per pair. This was U$10 less than the firm had sold the jeans for in the past (offering the potential for a 50% mark up) and half the cost of most other retailers. One buyer recommended taking a higher gross margin than was usual (i.e. more than the usual 14% mark up) as no one would know. Apparently Sinegal insisted on the standard mark up, arguing that if "I let you do it this time, you will do it again". "

Most supermarkets mark up goods in aggregate by twice as much (in margin terms) as Costco and even the mighty Wal-Mart marks up by half as much again as Costco. In order to make money at such low (gross) margins Costco must ensure that: (1) Operating costs are low, indeed very low. It is indicative of the paranoia with which the company is run that costs are measured in basis points (there are 100 basis points in one percentage point). This makes life difficult for Wal-Mart and the hypermarkets who cannot price at aggregate Costco levels and make money as their cost bases

(approximately 15% and 25% of revenues respectively) are too high. (2) That the wholesale price is as competitive as can be. The key to negotiating terms is that the number of items in a store (stock keeping units) are fixed at 4,000, and the right to fill one of these spaces is auctioned, with the supplier that provides the best value proposition to the consumer winning space on the shop floor! Contrast this to normal industry practice whereby the supermarket assumes the role of landlord, auctions space to the highest bidder and pockets the rents ("slotting fees" in industry parlance). Many supermarkets make their money from buying from the supplier. Costco makes money from selling to the consumer. The firm publishes the criteria required to become a Costco supplier on its UK web site. After setting out the definitions of quality, pricing, packaging and gratuities ("expressly prohibited" for reasons we can all understand) there is the following statement about purchasing quotes:

"We expect all vendors to consistently and voluntarily quote the lowest possible acquisition price available on all items. A vendor who does not consistently and voluntarily quote its lowest prices to our buyers will be permanently discontinued as a purchasing source for Costco."

Source: Costco.co.uk

Grief. One strike and you're out!

(3) Revenues need to be very high. This last factor is partly a self fulfilling prophesy – revenues will be high if the other factors, (1) and (2), are favorable. The issue is what the company then does with this revenue advantage. In the case of Costco scale efficiency gains are passed back to the consumer in order to drive further revenue growth. That way customers at one of the first Costco stores (outside Seattle) benefit from the firm's expansion (into say Ohio) as they also gain from the decline in supplier prices. This keeps the old stores growing too. The point is that having shared the cost savings, the customer reciprocates, with the result that revenues per foot of retailing space at Costco exceed that at the next highest rival (Wal-Mart's Sam's Club) by about fifty percent.

The stores are mainly owned rather than leased. This makes sense in terms of controlling costs (no greedy landlords putting up rents) but also means that growth is measured and predictable, if slower than Wall Street might like. But this is fine with us if it means that the probability of continued success is higher than under a going-for-broke expansion plan.

In the office we have a white board on which we have listed the (very few) investment models that work and that we can understand. Costco is the best example we can find of one of them: scale efficiencies shared. Most companies pursue scale efficiencies, but few share them. It's the sharing that makes the model so powerful. But in the center of the model is a paradox: the company grows through giving more back. We often ask companies what they would do with windfall profits, and most spend it on something or other, or return the cash to shareholders. Almost no one replies give it back to customers – how would that go down with Wall Street? That is why competing with Costco is so hard to do. The firm is not interested in today's static assessment of performance. It is managing the business as if to raise the probability of long term success.

Deconstructing the Investment Case for Costco Wholesale

What is it about growth stocks that dooms them to failure? In other words, why is Michael Goldstein's growth stock failure rate, and our shunning of Dell, normally right? The answer is that success encourages competition, and capital flows into an industry to compete away the excess returns. Like all heuristics, this works most of the time, and we can all think of businesses that were super profitable for a while before the competition caught on. But what of those that don't fail? Michael Dell succeeded by keeping costs low, and passing back his scale benefits to the buyer of his PCs. By the time the competition had matched him in pricing he had moved on. And on and on. (Perhaps someone could slip this letter into Carly Fiorina, Chairman and CEO of Hewlett Packard's suggestion box). Amazon.com may be following this path as well. So the first point is that whilst Costco continues to recycle cost savings to the consumer, it is lowering the probability of failure.

So what heuristics do investors incorrectly apply to Costco (why might the shares be mis-priced?). Heuristic One: "the company has low margins" (net profit margin is 1.7%, compared to Wal Mart at 3.6% and Target at 4.2%). True, but that's the point. The firm is deferring profits today in order to extend the life of the franchise. Of course Wall Street would love profits today but that's just Wall Street's obsession with short term outcomes. Heuristic Two: "its expensive at 24x earnings". Really? Net income is a small residual, as discussed above. The firm could earn Wal-Mart margins by taking pricing up a little, in which case the firm would be on 11x earnings, but would it be a better business as a result? We think not, if it allowed the competition to catch up. Heuristic Three: "Costco has a cost problem". Costs have risen as a percentage of revenues in the last few years due to the expense of a warehouse and distribution system associated with the next phase of the firm's growth and the cost of employee benefits and insurance, especially in California. This has people fooled who really should not be. At the annual general meeting for an investment company that we hugely admire, the investment firm's founder (and industry hero) was asked by an client why their holding in Costco was just 1% of the fund, especially when they have a reputation for portfolio concentration. The answer given was that of the firm's three constituencies (labour, customers and shareholders) the first two had been ascendant. This sounds nice and neat, but the phenomenon is cyclical: labour are "happy" according to Sinegal, Costco's founder and CEO, incremental stores will leverage fixed costs, and in the letter to shareholders Sinegal describes costs as "unacceptable". In short, they are on to it. Our investment hero was mistaken, by about U$20 per share so far, or a gain of 65%.

Is it perfect?

No. But that suggests an interesting question: What characteristics could one bestow on a company that would make it the most valuable in the world? What would it look like? Such a firm would have a huge market place (offering size), high barriers to entry (offering longevity) and very low levels of capital employed (offering free cash flow). Costco has some of these attributes. The range of products is as wide as any retailer, and by passing savings back it is building a formidable moat. It is also more asset light than its peers, but it is not the lightest of them all. For that one must turn to the Internet. In our opinion a business such as eBay could be the most valuable in the world. It has a huge market place, the biggest, an auction marketplace naturally

aggregates to one player, offering high market share and high barriers to entry to the winner. Product pricing may be supported by the incumbent local newspapers and publishing businesses which have expensive machinery to replace and usually unionised labour, and may provide a price umbrella for eBay. Better still eBay makes the customer pay for a high proportion of the assets used in the transaction such as PCs, modems, phone lines and so forth. But best of all, the incremental assets required to grow are so small. At Costco the firm will spend around U$15m per incremental store which will serve a radius of perhaps thirty miles. U$15m is a lot of servers for eBay, and whilst we are not experts, that may be enough to serve some countries. So no, Costco is not perfect. Perhaps we should own eBay as well.

What are the economics of our purchase of shares in Costco?

Readers that don't enjoy sweating the maths can resume at the next paragraph. Those that like a work out, read on. Analysis of the annual report (disgraceful lack of colour pictures) reveals that revenues of U$47.2bn (year to August 2004) represented a 12% mark up on "merchandising costs" and left enough to pay for operating costs (SG&A) of 9.8% of sales (one third of the hi-lo supermarkets). Profits from retailing are therefore around U$456m per annum to which one should add the membership fees of U$961m = U$1.41bn pre taxes. Taxes approximate depreciation most years, so pre-tax income equates to gross cash flow before maintenance capex which at around U$250m per annum implies around U$1.17bn in free cash flow as a cash cow. This compares to a fixed asset base of company owned real estate of U$9.6bn (depreciated value U$7.3bn). Working capital is "supplier funded" and means that the U$1.17bn free cash flow represents a yield of around 12% on fixed assets. A bear argument is that if the real estate was leased, free cash flow would be nought: this looks right but may miss two things: (1) Rents provide a return to their owners, not just break even on the cost of capital and (2) The store base is under-earning, perhaps significantly. Evidence for this is as follows: revenue per store at the oldest stores is twice this year's new openings, revenues per store at the oldest stores are still rising at 3 to 4% per annum, costs per new store suffer from low capacity utilisation of warehouses, and penetration in California is six times US State average. Store growth will be around 5% per annum and management confess to "always under-estimating saturation": in LA post the merger with Price Club in 1993 they thought 31 stores were too many for the market, but today there are 36. Likewise, in Seattle and Alaska the penetration of cards (membership) is 65% of households (gosh) but in most markets it is below 10%. Note also that one third of the store base remains in California, and almost half on the West Coast. This is a very young franchise. Half of the store base is over ten years old and earns 65% of the revenues whilst using approximately 40% of the asset base. What this means is that the oldest stores earn around 16.5% on assets and the youngest earn 6%. In other words there is an approximate 50% rise in aggregate profits to come as the store base matures (4% growth per annum), plus same store sales growth at the mature stores (approx 4% per annum) implying 8% growth before new store openings, which will add 5% to the store base and can easily be funded through free cash flow. This suggests normalised growth of 13%, and I don't think it is a stretch.

How do we think about valuation? There is a range of possible outcomes for the business, some are more likely than others, and in our mind they have various probabilities attached. What we present below is our assessment of central value for

Costco, but you should bear in mind that it is not the only value for Costco. Our average purchase price of U$39 per share (a blend of U$30 per share when the Partnership was small, and U$40 per share following the draw down of the Nomad subscription queue in the summer) discounts modest growth of 5 to 6% per annum, and is too low for a business that will be pushed not to grow earnings 10% per annum. A price of U$43 per share discounts 7% growth and U$85 to U$90 per share 15% growth. There is a very real possibility that the business could be priced to discount growth of 10% which would imply a price of U$62 per share today (and that price should rise by our 10% discount rate per annum). If it takes five years for the shares to converge on a price which discounts 10% growth per annum then the shares would need to rise by 20% per annum from our average purchase price of U$39 per share.

Such a gain would add around 2% per annum to Partnership assets. And it is this that makes me think the weighting in the portfolio is too small. If Dell is the appropriate model for Costco, then the probability of failure is lower than for most growth stocks. It is lower again when one considers self funded, as opposed to, rented growth. And lower again when one considers the fixity of mark up. To a far greater extent than for many businesses the company controls its own destiny. So what attracted us to Costco is the predictability of outcome: we don't think it is going to fail for many years. But is a 2% gain per annum optimal? If one applies the Kelly criterion (discussed in the last letter) the weighting should be much higher. So already your manager may have made his first mistake investing in Costco. From not buying enough. Perhaps I will get my opportunity to make amends.

So, the consensus has it that Costco is a low margin, expensive retailer with a cost problem. That is certainly one description. In our judgement it is a cost disciplined, intellectually honest, high product integrity, perpetual motion machine trading at a discount to value. The weighting in the Partnership may be too small, but even so as the description of the business migrates in the minds of the average investor from the former to the latter I think we will do quite well.

A Short Word on thinking about Business Values as opposed to Stock Prices

We go through this analytical process with each investment and have expressed our thoughts on Costco here to help illustrate that transient stock price quotations mean little to us (except as an opportunity set for incremental capital). And they should mean little to you. Ignore Nomad's performance so far. We own shares for multi-year periods and so our continued investment success has far more to do with the economics of the underlying businesses than it has to do with their last share price quote. In the last year or three, share price quotes happen to have been in our favour and they flatter your manager's input. You should not always expect this to be the case. There is no reason why business values and share prices should move hand in glove. You should expect that there will be a time when prices, and Nomad's performance, significantly lags the performance of our underlying businesses. It is then that we will ask you to be contrarian, and invest more.

How big is Nomad?

There is no getting around it, Nomad is stapled to a fund management organisation three hundred times its size. This was important for Nomad's genesis, and I wonder if

it would have survived this long if truly independent. But it is a problem also. Particularly when picking stocks. This is because your manager wears two hats, that of analyst to the main Marathon funds, and that of Portfolio Manager to Nomad. The problem comes when an order for Nomad is aggregated with those of the main funds. Then Nomad, whose own size is small, in effect behaves as if it was a U$30bn fund (Marathon's total assets under management). This is not ideal, but it is hard to devise a system which does not amount to a worse outcome for one party or the other. We struggle with a satisfactory system, but you should be under no illusion that Nomad's returns, such as they are, are a product of its size alone. We look like a mouse but move like an elephant. It is not a good combination, but it is what it is.

Thank you

We don't write to you that often, as measured by number of letters per annum. But the sum of the letters we write amounts to around ten per stock holding period (two annual letters times five years). On this measure we may be more communicative than many investors who write more often, but trade shares more frequently still. Even so, we like the balance as it is, and are hesitant to fall into "say-something" territory. We are very conscious that investors in the Partnership have reciprocated and allowed us to get on with our job of roaming the globe looking for value. Thank you.

On the administration side, please do call Daiwa Securities Trust and Banking in Dublin with your enquiries (+353 1603 9921). I am aware that there have been issues with the timely receipt of statements and accounts. We are on to it. Please do press them if you are not fully satisfied. They are here to help you, and you have paid for their services. Don't be shy, we aren't. Likewise, Alexandra Aitken at this office (+44 207 497 2211) is employed to help with basic performance and statement enquiries.

As always it is an absolute pleasure running this Partnership. We value your confidence in us very highly and thank you for your patience.

…back to the annual reports.

Yours sincerely

Nicholas Sleep

Appendix

Introduction to the Global Investment Review, September 2004.

"…this is a superpower in error-causing psychological tendency: bias from consistency and commitment tendency, including the tendency to avoid or promptly resolve cognitive dissonance. Includes the self-confirmatory tendency of all conclusions, particularly expressed conclusions, and with a special persistence for conclusions that are hard-won".

Charles T. Munger, speech at Harvard Law School, estimated date June 1995

It is not uncommon for plan sponsors and other clients to ask their fund managers to discuss their latest stock purchases. Perhaps the supposition is that these are the investments on which the manager is most bullish. Perhaps it is a test of conviction. Perhaps the client is looking for a tip, who knows? No matter how good the relationship between fund manager and client there is inevitably a bias at least to defend and at worse promote the purchase decision. We have all done this to some extent. It's only natural; the manager has made the decision to invest and is talking to the client, how can he not be upbeat? Promotion is one thing, and we can all adjust more or less for its effects, decades of company visits have honed that particular skill, but that is not the issue at hand. The issue is whether, in trying to convince the client of the merits of the case, the manager convinces himself. The danger is highlighted by Munger in the passage below:

"And of course if you make public disclosure of your conclusions, you're pounding into your own head. Many of these students that are screaming at us, they aren't convincing us, but they are forming mental chains for themselves, because what they are shouting out they are pounding in. And I think that educational institutions that create a climate where too much of that goes on are…in a fundamental sense, they are irresponsible institutions".

It is for this reason that in its purest form a fund management company's sales function (whose basic technique is to "shout out and pound in") can be counter-productive. And it is why the most successful salesmen (as measured by commissions earned over the short-term) are frequently void of rooted-in-reality objective thinking, such as is vital for good long-term investment performance. Either fund management companies are investment companies or marketing companies. Not both. At Marathon we think we understand this conflict but even we struggle, and we make no claim to maximise both functions. The fact is that sales and size are the two main detractors of long-term performance, after inability. To paraphrase Mr Buffett, should you come across individuals suggesting otherwise our advice is watch their noses, for signs of abnormal growth.

This is not to say that investors do not have the right to question their managers about stock picking – far from it. But both parties must be aware of what they are doing. Our thinking is that fund managers should have absolute conviction on the philosophy and methodology of their investment principles, providing of course that those principles reflect reality. But they should be circumspect about expressing these tenets as they relate to individual stocks. Evangelism is not healthy. The reason

is that, whilst fund managers have it in their powers to control the way they think, they are unable to control how their companies behave. Businesses evolve, companies make mistakes, business managers change their minds, share prices depart from reality – the investment manager can control none of these factors but needs to assess objectively each one for the risk of misanalysis. The issue is: in publicly disclosing his stock picking commitments, does the investment manager subtly and no doubt subconsciously rob himself of his objectivity and the option to change his mind? To deny this takes place seems foolhardy. The question is, how many recognise the risk of dysfunctionality, and adjust their behaviour? Certainly those consultants and plan sponsors that insist upon frequent, detailed, blow-by-blow reporting may be surprised to learn that their seemingly reasonable request risks being counterproductive. Consultant meetings, which aggressively bear down on the microeconomics of an individual business, seem designed to form mental chains that neither side needs to bear. But where does that leave monthly reporting, quarterly reporting, annual reporting, and even this publication?

Fund management errors are not the only ones that result from over-promotion activity. Quarterly, or even monthly, client reporting routinely marks fund management performance to market and these result snapshots acquire an extra validity, simply by virtue of their being reported. At Marathon a full holding cycle can exceed 5 years, so any quarter individually considered could be poor without affecting long-term outcomes. For those keen on monthly results there will be 60 such data points in a full holding cycle. These data points, in the hands of an inexperienced investment committee, could be misconstrued or worse. After all, most of Marathon's client termination events occurred after, rather than before, a period of underperformance. According to Munger, it is a common psychological tendency that people overweigh the vivid evidence (or recent experiences). This is clearly what can happen via the mark-to-market effects of quarterly reporting. The "Pavlovian" association of poor short-term results with long-term incompetence and confusion between the two can lead to disastrous decisions. Today this risk is greater than ever because, relative to history, consistency of investment performance is an attribute prized almost above all others in some parts of our industry.

At a New York cocktail party populated by investment professionals this author clumsily asked one fund manager what his largest holding was. My acquaintance's response was to decline to answer for reasons that this essay makes plain. His response seemed rude in a social setting, at least to this author, but having thought about the issues for about a year, it was perhaps the highest quality answer he could have made. He certainly understood elementary psychology.

CONFIDENTIAL DRAFT

Perpetual Growth Machine

While Costco shares aren't cheap, value investor Nicholas Sleep shares some fascinating insights about the company and makes an excellent case for its long-term prospects.

Value investors have long been intrigued by Costco Wholesale Corp. It has a fabulous long-term record of steady growth, it's old-school in its management and compensation practices, Berkshire Hathaway's Charlie Munger is on the board – plus, any bargain hunter loves to shop there. Not so many value investors own the stock, however, in part because it has extremely low margins – less than 2% after tax – and the stock rarely looks cheap, trading today at 25x trailing earnings per share.

So we didn't expect anything particularly new when we sat down to read the discussion of Costco in the annual letter of Nicholas Sleep of London's Marathon Asset Management. But Sleep's fresh insights, arguments and analysis – "Mungeresque" in tone and content – persuaded us that Costco's intrinsic value is probably quite a bit higher than we'd thought. We followed up with him to learn more on why he believes, even if it's not a 50-cent dollar, Costco is an outstanding long-term investment.

Customer really is king

Retailers love to boast that the "customer is king," but none live it like Costco. It starts with how the company negotiates with suppliers. As Sleep notes:

"Costco's key to negotiating terms is that the number of items in a store (SKUs) is fixed at around 4,000, with those suppliers that provide the best value proposition to the consumer winning space on the shop floor. Contrast this to normal industry practice, where the supermarket assumes the role of landlord, auctions space to the highest bidder and pockets the rents ("slotting fees" in industry parlance). Many supermarkets make their money from buying from the supplier. Costco makes money from selling to the consumer."

Costco fixes its retail prices at a maximum of only 14% over the company's cost – with no exceptions. This pricing discipline – even Wal-Mart's mark-ups are around 20% – engenders outstanding customer loyalty. As the company has raised its annual membership fee over time, to $45, membership renewal rates have barely budged from an enviable 85%.

The real power of Costco's strategy – and the source of its competitive advantage, according to Sleep – is how the benefits of growth are reinvested in the relationship with the consumer. As Costco opens new stores, supplier and other scale cost savings are passed back to customers through even more compet-

INVESTMENT SNAPHOT

Costco Wholesale Corp.
(Nasdaq: COST)

Business: Membership warehouse retailer offering members low prices on limited selection of branded and private-label products across multiple product categories. Primary operations in U.S. and Canada.

Share Information
(@2/17/05):

Price	46.10
52-Week Range	35.05 - 50.46
Dividend Yield	0.85%
Market Cap	$21.66 billion

Short Interest:
(@1/10/05)

Shares Short/Float	2.47%

Financials (TTM):

Revenue	$49.16 billion
Operating Profit Margin	2.91%
Net Profit Margin	1.86%

Valuation Metrics:
(Current Price vs. TTM)

	COST	S&P 500
P/E	24.0	23.1
P/CF	16.0	13.9

Largest Institutional Owners:

Company	% Owned (@ 9/30/04)
Davis Selected Advisers	7.86%
Barclays Bank Plc	3.64%
State Street Corp.	2.73%
Capital Guardian Trust Co.	2.32%
Vanguard Group	2.18%

COST PRICE HISTORY



THE BOTTOM LINE

Costco's "perpetual machine" of growth is capable of keeping company revenue and cash flow growing 13% annually, says Nicholas Sleep of London's Marathon Asset Management. If the market price reflected even a 10% growth expectation, he says, COST would trade at $62, a 34% premium to the current market price.

Sources: Company reports, other publicly available information.

CONFIDENTIAL DRAFT

itive prices. Customers then respond to the better prices, driving incremental revenue at both new and old stores. As Sleep writes:

"In the office we have a white board on which we've listed the very few investment models that work and that we can understand. Costco is the best example we can find of one of them: scale efficiencies shared with customers. We often ask companies what they would do with windfall profits, and almost no one replies 'give it back to customers'. How would that go down with Wall Street? That is why competing with Costco is so hard to do. The firm is not interested in today's static assessment of performance. It is managing the business to raise the probability of long-term success."

By sharing the cost savings of growth, Costco earns revenues per square foot – around $830 – that are the envy of the industry. Wal-Mart's Sam's Club checks in at around $500 per square foot, while BJ's Wholesale Club is about $400. Even more importantly, Sleep estimates that mature Costco stores – open at least five years – generate revenue of over $1,000 per square foot.

Margin trouble?

Costco's pricing discipline, by definition, keeps margins low – at 1.9%, they are roughly half those of Wal-Mart (3.6%) and Target (4.1%). Sleep argues that Wall Street's focus on margins is short sighted:

"True, the company has low margins, but that's the point. The firm is deferring profits today in order to extend the life of the franchise. Of course Wall Street would love profits today, but that's just Wall Street's obsession with short-term outcomes. The firm could earn Wal-Mart margins by taking pricing up a little and the stock would then trade at 11x earnings, but would it be a better business as a result? We think not, because it might allow the competition to catch up."

Contributing to margin pressure in recent years has also been a rise in SG&A costs as a percentage of revenues, fueled in large part by spending on a new warehousing and distribution system and rising employee wages and benefits. A sign of trouble? No, explains Sleep: "We clearly differentiate between 'good' and 'bad' SG&A spending," he says. "In both of these cases, Costco is investing in areas critical to its growth." With the new warehousing system in place, efficiency gains will start showing up in the financials this year. And the slightly higher wage base helps Costco retain its employees twice as long as competitors do, which Sleep sees as positively impacting customer service and contributing to its very high customer retention.

PRIVILEGES OF MEMBERSHIP



Costco's membership-only model helps foster a unique relationship with its customers. People shop there because it's Costco, not because it stocks Pepsi or Pampers. As Costco has raised its basic annual membership fee over time, to $45 currrently, membership renewal rates have barely budged from an enviable 85%.

Still an early life-cycle company

Even with annual sales of nearly $50 billion, Sleep makes a compelling case for Costco as a growth company, through geographic expansion, increased market penetration, and the virtuous cycle of growth in maturing-store asset turns as scale efficiencies result in even lower prices.

"One-third of the store base remains in California, and almost half on the West Coast. Management always confesses to underestimating saturation. In Los Angeles, for example, after merging with Price Club in 1993, Costco thought 31 stores were too many for the market, but today there are 36. Likewise, in Seattle and Alaska, the penetration of membership cards is an astonishing 65% of households, but in most markets it is below 10%."

All told, Sleep estimates that Costco can conservatively increase revenue and free cash flow by 13% per year into the foreseeable future – 4% from the increasing asset turns of newer stores as they mature, 4% from same-store growth at already-mature stores, and 5% from new stores.

"This is an early life-cycle company whose competitive moat gets deeper as the company gets bigger and the consumer is consistently cut-in on the benefits of the company's growth," Sleep says, terming this cycle a "perpetual machine" of growth.

The market, which currently prices Costco shares at around $46, is not so generous in its growth expectation. Sleep calculates that if Costco shares were priced to reflect just 10% annual growth, the stock would trade at $62 today. Even at that price he wouldn't sell, he says, given his expectation for even faster growth.

What could go wrong? Wal-Mart, with Sam's Club, could mount a sustained direct attack to undercut Costco's prices. Sleep considers that unlikely, as Costco has shown itself more than capable of competing head-to-head with the discounting giant. The departure of CEO James Sinegal, 68, the architect of Costco's unique and disciplined culture, could also be a blow. Sleep points out that Sinegal shows no sign of slowing down, and that Costco's experienced board can be counted on to appoint a worthy successor.

We'll leave to Marathon's Nicholas Sleep the final word on Costco: "The consensus has it that Costco is a low-margin retailer with an expensive stock and a cost problem. That is certainly one description. But in our judgment it is a cost-disciplined, intellectually honest, high-product-integrity, perpetual motion machine trading at a discount to value." VII

Nomad Investment Partnership.

Interim Letter.
For the period ended June 30th, 2004.

Nomad's year to date performance is sufficiently close to the index (at the time of writing the differential is just 2%) to raise an eyebrow given the disdain with which we hold closet index managers. These are a sub-specie of professional fund managers that charge high active management fees whilst delivering index-like (i.e. non-active) performance. We can promise you that any resemblance Nomad may have to the closet index trackers is entirely coincidental. Our portfolio is nothing like the index. Indeed, it is not quite like anyone else's. And note, unlike the closet index trackers, at Nomad, no performance means no fees. That is the way it should be. (A notion to be slipped into your mutual fund manager's suggestion box!).

That said, the Nomad Investment Partnership Limited Partners interest and Nomad Investment Company Class A share gross results (i.e. net of management fees and costs, but before performance fees) for the last six months, trailing one and two years, as well as since inception (before and after performance fees) are tabled below on a compounded basis, together with comparable results for a leading global stock market index (also see appendix):

To June 30th, 2004	Nomad Investment Partnership	MSCI World Index (net) US$
6 months	-0.97%	+3.52%
One year	+41.14	+24.00
Two years	+73.48	+21.06
Since inception (10/09/01)	+98.50	+14.37
Annualized since inception		
Before performance fees	+27.38%	+4.85
After performance fees	+23.14	

For those investors that joined part way through, or who despite our haranguing remain closet short-term oriented, the table below describes performance in increments (again, see appendix):

To June 30th, 2004:	Nomad Investment Partnership	MSCI World Index (net) US$
2004	-0.97%	+3.52%
2003	+79.64	+33.11
2002	+1.30	-19.89
2001 (inception 10/09/01)	+10.14	+3.61

Partnership Governance

In May, the balance of the funds waiting to be invested in Nomad were drawn down at a time when stock prices allowed us to lower the price to value ratio of the Partnership, and when insider buying and share repurchase picked up at investee companies. The bulk of this incremental capital was invested and leaves a cash balance of around 16% of assets. This too will be invested as and when prices allow. The Partnership has grown considerably in the last eighteen months to just over U$100m, and should now be considered closed. This is our natural state of affairs, and one that will be punctuated with open periods in response to price opportunities.

Job one, two and three for your manager is investment performance, not asset gathering. Few practice this approach. We work under the assumption that if performance is reasonable then the level of interest in what we are doing will increase and, if appropriate, the Partnership will grow in time. Common sense and simple maths dictate that it will be opportune if growth can be channeled to coincide with depressed prices, and not market tops. We must aim for this standard, even though it is contrary to common practice in the industry. Had we adopted the industry standard open-house approach the Partnership would be approximately three times its current size, but the results worse, and the quality of Partners meaningfully impaired. It is important to us that we all understand the investment process (a reminder is contained in the appendix, in the form of an interview published in the Outstanding Investor Digest), try hard to keep a healthy indifference to results achieved (certainly no extrapolation of annual results please) and maintain a patient temperament. Investment dollars work best when they occupy a different psychic space to almost any other form of savings you may have.

The size of any future reopening will be proportionate to the opportunity set: a melt-down in large capitalization shares (please), a debt market swoon like the one recently experienced in the US, or an emerging market crisis as occurred a few years earlier, would allow the Partnership to be many times its current size and improve its potential returns. Today, the opportunities are mainly small and mid-capitalization companies, especially in Asia, and mainly turnarounds in nature (which bring with them reinvestment risk once the stock is sold). And so, for the time being the Partnership will retain its modest size. Over time this may change, but the timing of that change is outside our control.

When we do reopen, we will write to those that have expressed an interest in investing more. This is likely to occur during periods of market stress and we will have to trust that indications made during rosier times turn into contrarian subscriptions. Very few organizations practice this common sense approach because they understand how human nature works. They suspect (or know!) the average investor will be bearish at the bottom. There is no point taking that particular horse to water. At Nomad, we believe our Partners to be exceptional. Take the drawn down of the queue in May. Within forty-eight hours of indicating our preference, all those in the queue had consented to subscribe their full amount, at little notice, and with several offers for more if we wished. Wonderful. And thank you. You have quietly let us get on with the job of investing without the prodding and poking that is common place throughout the industry. In turn, we have felt trusted and free to invest in ways we think is appropriate to the benefit of all our results. We are aware that the industry's record in raising capital at market lows is not good. But we are happy to trust you to be contrarian at the next market swoon.

Current State of Partnership Investments

Growth in the Partnership and disparate performance of individual holdings means that the distribution of Partnership investments is a little more diffuse than would normally be the case. Ten holdings still make up almost half of the Partnership, but there is a tail of smaller investments from the early days, which were sizeable at one time, and now bring the total number of holdings to just over thirty. In effect, we are building a new portfolio (the ten large holdings) within the old portfolio (the tail). Around one third of Partnership assets are invested in companies in South East Asia, one fifth each in the UK and the US and one-tenth in Europe. Approximately seventy percent of the Partnership is invested in common shares, ten percent in corporate bonds (distressed) and the balance held in cash on deposit. The estimated price to value ratio of the Partnership is 61c on the dollar, down slightly from the end of the year due to the new investments.

We have holdings ranging from almost 7% to 0.3% of assets. At the time of writing, Jardine Matheson/Strategic and Costco Wholesale are around 6.5% of Partnership assets each, Xerox 3.1%, but Union Cement around 1% and Velcro 0.6%. Why? A consequence of price discipline is that one cannot be certain of the size of the investment opportunity in advance. We simply cannot be sure how many people will be prepared to sell to us at our price: it may be 20 shares or 20% of the company. We hope for the latter but more recently have found it to be the former. An extreme example has been our attempt to purchase shares in Union Cement. This is the Philippines' largest cement company and has been priced in the market at around one quarter of the replacement cost of its assets. The assets are world scale and reasonably new, or at least were constructed during the Asian tiger boom of the early 1990s. The low valuation of the company in the markets had the desired effect in reducing capital investment (why spend discretionary resources on shiny new assets when the market valued them at 25% of cost?) and free cash flow was instead used to repay debt. Despite the turnaround in strategy, investors barely seemed to notice and the shares, which had already fallen from U$0.30, bounced around between 1 and 2c a share. We started buying and in doing so raised the price over a six-month period from 1.5c to 2.5c and despite being almost the only buyer of shares we managed to purchase just

U$1m worth of stock. This is remarkably little when one considers that Union Cement is a large company with a market value of U$200m and around U$700m in gross assets. The shares simply would not trade, indeed the average holding period indicated by share turnover during much of this period implied a 40+ year outlook by investors, coincidentally comparable to the life of a cement plant. Of course the more undervalued the company became the less the shares traded, as more holders understood the under-valuation. But still we plugged along in the hope that as the price rose we would be able to secure some more stock. This was not to be. By the time Holcim, one of the world's largest cement companies, purchased a control block in the firm at an effective price for Union Cement of close to 10c (US) a share, five times our average purchase price, we had secured only a small holding. It is possible that we could have made Union Cement a meaningful ten percent investment in the Partnership. As it was, and despite our best efforts, we managed to achieve a miserable 1% investment. Charlie Munger is right when he says, "it is aggravating to just buy a bit".

Our thoughts on Portfolio Concentration

As the cash is invested, portfolio concentration will rise. In theory, if we could find fifty ideas at equal discounts to value, with equal probability (conviction) of value being realized, then they could all be equally weighted in the Partnership. We could all then look forward to a nice smooth rise in the value of our shares in Nomad, free from the swings a more concentrated portfolio might create. But life is not like that. In reality opportunities in which we are comfortable to deploy capital are rare, and the highest conviction ideas the rarest of them all. The issue then is how much to invest in each idea? Bill Miller, who has run the Legg Mason Value Trust so brilliantly for many years, suggests the use of a system devised in 1956 by J. L. Kelly. A simplified version of the Kelly criterion is that investors should bet a proportion of the portfolio equal to 2.1 x p - 1.1, where p is the probability of being right. The common sense outcome of this equation is that if one is certain of being right, one should invest the entire portfolio in that idea. Even if one is say 75% certain of being right the correct weighting remains high at 47.5% ((2.1 x 0.75) – 1.1). But does anyone do that? As far as we are aware, only the early Buffett Partnership portfolios had anywhere near this level of concentration, and then mainly in companies in which Buffett was a controlling shareholder. But is this not the right way to think? If you know you are right, why would you not bet a high proportion of the portfolio in that idea? The logical extension of this line of thought is that Nomad's portfolio concentration has at times been too low. And if it has been too low at Nomad, what has been going on at the large mutual fund complexes with many hundred stocks in a single country portfolio? Apply the Kelly criterion, and the average fund manager would appear to have almost no clue as to the likely success of any one idea. In our opinion, the massive over-diversification that is commonplace in the industry has more to do with marketing, making the clients feel comfortable, and the smoothing of results than it does with investment excellence. At Nomad we would rather results were more volatile year to year, but maximized our rolling five-year outcome. If you do not share this view, think long and hard about your investment in Nomad.

One of the consequences of industry-wide over-diversification

Parents will understand when I say that when children are born, they seem to bring their own love with them. However, stocks are not like children. The more stocks you own the less you care about each one individually. Attention paid to corporate governance, capital allocation, incentive compensation, accounting, and strategy has to be diluted as the number of stocks rises. Alternatively, armies of analysts are drafted in, risking a decline into committee-based decision-making. When over-diversification becomes the industry norm then in aggregate investors risk failing to police bad corporate behavior. Would fund managers be so liberal with dysfunctional management if the holding was 20% of the portfolio rather than 0.2%? Of course not. Perhaps some of the scandals of the last few years would have been averted if fund managers had been more proprietorial about their holdings.

However, there are some glimmers of hope. We have been inclined to think of the largest shareholders in publicly listed companies as general partners. This works better with some fund management organizations than others, but the influence that a large properly oriented outside shareholder can have over corporate behavior should not be under-estimated. At Jardine Matheson, Brandes Investment Partners (the largest outside shareholder) proposed, and Marathon seconded, a motion to reorganize the firm. Although this proposal failed as management voted against via their shares in sister company Jardine Strategic, a watered down version of the Brandes strategy has been pursued ever since and with wonderful results. At Kersaf, Allan Gray Limited and Marathon combined votes to propose an about-turn in company strategy. The strategy (all Allan Gray's work, not ours!) has proved to be excellent, and the share price of Kersaf has doubled in rand (and risen almost four fold in dollars). At Hollinger International, Tweedy, Browne Company have professionally and selflessly pursued former Chairman Conrad Black to recover funds paid to him, and in the process have realized the private market value of the newspaper properties resulting in a doubling of the shares from Nomad's purchase. Our input has been limited to private correspondence with Lord Black, which is framed and may be viewed at Marathon's offices. Should you meet representatives from any of these fine investment-oriented fund management organizations buy them a drink. They have added greatly to your returns.

And lest you think Marathon has not been pulling its weight, at HCI, the owner of eTV, South Africa's independent commercial TV station, Marathon is in the process of resisting in Court, an attempt by management to buy the firm against our wishes at what is demonstrably (and management agree) a massive discount to its real value. These actions are time consuming and expensive, but appropriate. To stand by and watch whilst we are having our wallet lifted makes little sense to us. Selling the shares and buying something else does no one any good either, even though this is common practice in the industry. As we wrote in the last letter:

"…the best defense is to own enough of the company to influence the outcome. In most cases in excess of 10% of the shares outstanding would suffice. Those that advocate market liquidity of their investments over other considerations might like to bear in mind an investor's inability to influence outcomes whilst owning a de minimus proportion of a company. Should Nomad continue to grow in size, we intend not to make this mistake".

The likely evolution of Partnership Investments.

In the office we keep a list of companies assembled under the title "super high quality thinkers". This is not an easy club to join, and the list currently runs to fifteen businesses. Entry is reserved for the intellectually honest and economically rational, but that alone is not enough. There are many companies that do the right thing when their backs are against the wall, and this list excludes those temporarily attending church. The anointed few are there because they have chosen to out-think their competition and allocate capital over many years with discipline to reinforce their firm's competitive advantage. Good capital allocation takes many forms and does not necessarily require a firm to grow. The Partnership's successful investment in Stagecoach has been due to the firm's shrink strategy, not its growth, although that may come in time. At National Indemnity (an insurance subsidiary of Berkshire Hathaway), the firm's ability to write insurance only when pricing is good and stand back when pricing is poor, even if revenues decline by 80% and remain depressed for many years, is a wonderful example of capital discipline and good capital allocation. After all, why grow if returns are going to be poor? However, surprisingly few companies have the strength to just sit it out, or shrink, as the pressure to grow is often overwhelming. The clamor comes from within the company (reinforced by poorly constructed incentive compensation), Wall Street promoters and short-term shareholders. When faced with this barrage, the voice of the long-term shareholder often goes unheard. We ask companies with poor economics why they want to grow. And senior management, with their hands on our purse strings, look back at us incredulous at our line of questioning. It is just not that easy to resist the urge to grow, even if economic results look so so. The "super high quality thinkers" are our best guess of those firms whose shareholders could abdicate their right to trade stock (allocate capital themselves) sure in the knowledge that their capital will be well allocated for years to come within the businesses. This list is a group of wonderful, honestly run compounding machines. We call this the "terminal portfolio". This is where we want to go. The question is, why is this list not the same as the current Nomad portfolio?

This is not an easy question to answer. But let us return to the church analogy for a moment. When we think about companies, the over-riding analytical consideration is the quality of the business and quality of management's capital allocation decisions. The longer investors own shares the more their outcome is linked to these two metrics. What separates a corporate hero from a loon is an intellectually honest appraisal of business prospects, and armed with that knowledge an appropriate allocation of discretionary resources. There are only two reasons companies behave well. Because they want to, and because they have to. Our preference is to invest in those that want to. If we can find enough of these heavenly opportunities they will in effect put us out of a job, and you should be pleased with this happy outcome (even we will be pleased, if a little bored). The problem of course is price. In paying up for excellent businesses today, investors are already paying for many years growth to come, in the hope that, as the saying goes, "time is the friend of a good business".

We can all observe that stock prices, set in an auction market, are more volatile than business values. Several studies and casual observation reveal that individual prices oscillate widely around a central price year in year out, and for no apparent reason. Certainly, business values don't do this. Over time, this offers the prospect that any

business, indeed all businesses, will be meaningfully mispriced. Even the mighty Berkshire Hathaway with its stalwart long-term shareholder base was demonstrably half priced in early 2000. And Marathon bought shares (unfortunately pre-Nomad inception). It is just a matter of time. Those that chase high prices today, leave less gunpowder for the future. In effect, they value future opportunities close to nil. So opportunity cost is partly behind our decision as well. Today, we have made two investments in wonderful compounding machines, and only one of those is meaningfully represented in the portfolio (Costco Wholesale). What is the probability that say, over the next ten years, a good portion of these "super high quality thinkers" will be priced at 50c? Our betting is that the odds are reasonable. Even though prices are generally high, the trick is to do the work today, so that we are ready.

And finally, the usual Housekeeping and a reminder on the Need for Patience

This final section may look familiar, as it is in part repeated from previous letters. However, this time we have included some thoughts on how we would like to be measured. The section may also be worth reiterating for those that have invested recently, or are reaching the end of the letter for the first time (congratulations).

You can expect from us an annual and interim letter (this is our third interim letter) and Global Investment Reviews eight times a year in which we discuss our investment thoughts. In our opinion these documents, once digested, provide the information needed to form a judgement about what and how we are doing. From Nomad's administrator (Daiwa Securities Trust and Banking, +353 1603 9921 for your inquires) you can expect a monthly statement of your account and annual and interim financial statements. Do call them if you are not receiving all you should. Nomad's orientation is genuinely long-term, and more regular reports, daily, weekly, monthly, or otherwise, are likely to be of little value to you, and may even be counterproductive.

One of Nomad's key competitive advantages will be the aggregate patience of its Partners. We are genuinely investing for the long-term, in undervalued firms run by management teams who may be making decisions, the fruits of which may not be apparent for several years to come. Our preference is to be measured over a rolling five-year basis; consistent with time it takes for many large capital allocation decisions to bear fruit and the average period that we expect to own an investment. (Our framework for thinking about a typical purchase and expected returns was laid out in the December 2003 letter and is contained in the appendix to this letter.) If Nomad is to have a sustainable comparative advantage, this will come from the capital allocation skills of your manager and the patience of our Partners. In the latter we have started well, with no Partner turnover since we began and almost no enquires into performance despite the swings in general market prices. This is very unusual and a huge credit to our Partners, and implies a similar long-term outlook. Only by looking further out than the short-term crowd can we expect to beat them. It is for this reason we named Nomad an Investment Partnership and not a fund (and certainly not a hedge fund!). The relationship we seek is quite different.

We work hard at being as thorough and thoughtful as we can in making investment decisions. We do this conscientiously and have our own money on the line with you. It seems a considerable anomaly to us that the plethora of new investment boutiques

and hedge funds that have emerged in the last few years have ostensibly the same investment process – short term, leveraged and news flow dominated. For our part we have no interest in such get-rich-quick schemes, and prefer to make money the old fashioned way, through thoroughly researched and thoughtful stock picking, with a bias toward portfolio concentration and very low levels of turnover. This approach requires patience but suits our temperament and we believe will lead to satisfactory results in the long run.

As always, we thank you for your confidence and value your support.

Yours sincerely

Nicholas Sleep

Appendix 1: A Typical Purchase, Expected Returns, and Portfolio Management

This section was originally contained in the December 2003 letter to Partners.

An index has been included along with results at the beginning of this letter, not for the purpose of explicit benchmarking but in order to place performance in context. Nomad is an absolute return Partnership, which raises the question: what returns are we trying to achieve? At this point regular readers may feel that in trying to discuss prospective returns we are skiing off-piste. However, we would rather expectations were sensible rather than risk any mental extrapolation of historic results. To help illustrate the returns we aim to achieve, it may be helpful to explain what we are thinking when we buy a share.

Our aim is to make investments at prices we consider to be fifty cents on the dollar of what a typical firm is worth. Capital allocation by investee companies must be consistent with value creation and, if this is the case, we expect that the real value of the business (the 100 cents value) could grow at around 10% per annum. The effect over five years will be to compound U$1 of value into U$1.62, and companies that can build value like this are normally rewarded in the market with a fair valuation (i.e. are priced close to U$1.62). This happy outcome would imply a return from purchase price (50 cents) of around 26% per annum. So, what happens when we are wrong? Our most common mistake is to misjudge capital allocation decisions by our companies: firms which articulate a share repurchase/debt repayment strategy and have incentives to reinforce that outcome, throw caution to the wind and make acquisitions instead. The Partnership's investment in Readers Digest falls into this category. Capital allocation mistakes such as these often prevent the compounding of value but to date have rarely resulted in a permanent decline in the share price to below our purchase price (50 cents). We have therefore tended to find that our mistakes atrophy (stay cheap) rather than collapse, although we can all name one collapse!

If over five years our mistakes are on aggregate flat, and our mistakes total half of Partnership assets, then this implies a compounded annual return of 13% for the portfolio as a whole[2]. Not each year, and maybe not for several consecutive years, but over time this level of expectations appears reasonable to us. This model is daftly precise, a little too neat and the one thing we can almost guarantee is that returns will not be exactly 13%. It is important however that we all understand the investment process and time frames involved.

The prime determinants of outcome are price (sticking to 50 cents on the dollar) and capital allocation by management. The first is in our control, that is, it is in our control to be patient and wait for the right price. The second involves a subjective judgment about the quality of management, and an assessment about the sustainability of business returns in the long run. It is these factors that occupy almost all our time.

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[2] Marathon Counsel: This is a hypothetical illustration only based on the assumptions set out above and is neither an indication or guarantee of the actual performance of the Partnership nor is it intended to form part of the investment objective of the Partnership.

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PERSPECTIVES AND ACTIVITIES OF THE NATION'S MOST SUCCESSFUL MONEY MANAGERS.

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(and more.)

OID MAILBAG
"ANYBODY CAN OWN WHAT THEY LIKE.
THE CHALLENGE IS TO OWN WHAT YOU *HATE*."

In his first letter to Heritage Value Equity Fund shareholders since taking over management of the fund, David Dreman discusses his investment approach, his current outlook and some of his favorite equity selections.

And then, in his most recent *Global Investment Review*, first-time contributor Nicholas Sleep touches on the concept of the equity yield curve and how to take advantage of it.

(continued on page 2)

OAKMARK FUNDS'
BILL NYGREN
"IN 2003, IT PAID TO AVOID EARNINGS AND DIVIDENDS.
BUT I WOULDN'T COUNT ON THAT CONTINUING."

From its inception on 11/1/96 through 12/31/03, Oakmark Select's shareholders have earned a compound return nearly three times that of the S&P 500 —22.2% vs. 8.1% —thanks to manager Bill Nygren (and co-manager Henry Berghoef since March 2000). Of course, we wouldn't ordinarily put too much weight on a seven-year record —

(continued on page 6)

BERKSHIRE AND WESCO ANNUAL MEETINGS
WARREN BUFFETT & CHARLIE MUNGER
"WHAT MAKES THE INVESTMENT GAME GREAT
IS YOU DON'T HAVE TO BE RIGHT ON *EVERYTHING*."

Anyone investing $10,000 in Buffett Partnership, Ltd. at its inception in 1956 who reinvested the proceeds into Berkshire Hathaway at the partnership's termination in 1969 would today own shares worth over $340 million. And that's *after all taxes, fees and expenses*. Just in case that's not sufficiently mind numbing for you, consider that before fees, but after taxes, the value would've been closer to *$600* million.

(continued on page 23)

SEMPER VIC PARTNERS' TOM RUSSO
"SOME CHEAP, HIGH-RETURN COMPANIES
SET TO CAPTURE LOTS OF INCREMENTAL GROWTH"

Under the direction of Gardner Russo & Gardner's Tom Russo, Semper Vic Partners has earned a compound annual return net of all fees and expenses for the 20 years ended December 31st of 18.5% versus 13.0% for the S&P 500. As we told you last time, its worst loss for any year was 2.1%. And during the the three years ending 12/31/02 — a period in which the S&P was down 14.6% per year — his clients were actually *up* over 4.6% per year after all fees and expenses.

(continued on page 53)

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OID MAILBAG:
MARATHON — LONDON'S NICHOLAS SLEEP
(cont'd from page 1)

Global Investment Review
September 30, 2003

THERE'S A YIELD CURVE IN EQUITIES, TOO.
AND TODAY, IT'S PRETTY STEEP....

We agree with Bill Miller. We own what we *hate*....

Nicholas Sleep: Regular readers [of our *Global Investment Review*] will be familiar with our contention that there are two areas of persistent mis-pricing: First are high quality, high return, high growth businesses where the stock price anticipates a decline in corporate performance that fails to materialize. Examples within current U.S. portfolios include Moody's Corporation, Costco, International Speedway and Ethan Allen.

Second are disasters (other people's that is) where business valuations anticipate dreadful performance for years to come. These companies are usually despised by investors and seen as controversial. And examples such as Primedia, Xerox, Nortel and Solutia populate our portfolios. Bill Miller, famed manager of the Legg Mason Value Trust, is fond of saying that "most fund managers own what they *like* to own. We own what we *hate* to own".

There is a strong element of this kind of thinking to the Marathon portfolios at the moment....

There's a yield curve in equities, too.

Sleep: Why do these anomalies persist? A critical role is played by the ever-shortening timeframes adopted by institutional investors. In consequence, longer-term opportunities are typically forgone. The problem with shorter holding periods is elucidated by the notion of the "equity yield curve". For this, we are indebted to Murray Stahl and Steven Bregman at Horizon Asset Management who brought the concept of an equity yield curve to life in [New York-based] *Grant's Interest Rate Observer* ([in their] December 22, 2000 [issue])....

A yield curve will be familiar to bond investors, but is rarely used to describe the stock market — the main conundrum being that equities have uncertain cash flows and no fixed redemption date. Equity, after all, is equity.

And the equity yield curve rises steeply after 18 months....

Sleep: But it is possible to plot the expected return for mandatory redeemable preferred shares where yield and duration are known and credit risk is minimal. In the original article, Bregman argues that the yield curve starts at Treasury rates of return and rises gently in line with bond yields for 18 months — i.e. it's "pretty efficient".

However, after 18 months the curve rises steeply to as high as 35 at two years (his study was performed at the end of 2000). We can't say we have seen too many 35% per annum propositions recently — at least not without taking on credit risk too. But Bregman's observation is important as it provides some theoretical underpinning for the structure of equity returns.

The question is, "Why?" And here's the answer....

Sleep: Why do mutual fund managers — who own shares on average for 11 months — invest at the Treasury end of the equity yield curve where returns are the lowest?

The answer probably lies in the error of their trying too hard to remove short-term share price volatility from portfolios (often referred to as, or confused with, "risk"). The effect is to prize the near term, more certain outcome. Furthermore, a liquid stock enables a swift exit just in case the investment decision proves wrong.

It is not surprising that General Electric is admired by investors for its low volatility of earnings growth and its huge and liquid market capitalization. Conversely, the dislike of earnings volatility is evidenced by the decline in the share price of Estee Lauder after the firm announced that earnings would fall short of expectations because advertising and marketing were being raised. It's not so much the advertising spend (surely the sellers that day did not really think advertising and marketing destroys value?) — rather it is the earnings disappointment that the ad spend creates which investors object to.

PORTFOLIO REPORTS estimates the following were Marathon Asset Mgm't Ltd's largest U.S. equity purchases during the 3 months ended 9/30/03:

1. SABRE HOLDINGS CORP CL A
2. SCHERING-PLOUGH CORP
3. SOLUTIA INC
4. WASTE MGMT INC
5. SUN MICROSYSTEMS INC
6. NEXTEL COMMUNICATIONS CL A
7. LUXOTTICA GROUP SPA ADR
8. IMS HEALTH INC
9. XEROX CORP
10. BERKSHIRE HATHAWAY CL B

FOR EXAMPLE, TAKE SCHERING-PLOUGH — PLEASE.
WHEN IT RAINS, IT POURS. MURPHY WAS AN OPTIMIST.

SGP has a pretty steep yield curve. And here's why....

Sleep: What is the shape of the "equity yield curve" today? There are several mandatory redeemable preference shares that are priced to yield 8-15% to maturity in four to eight years. But these, unsurprisingly, are fairly illiquid. However there are several U.S. businesses that imply that the shape of the curve is still pretty steep. Take for example Marathon's recent investment in Schering-Plough. [Ed. note: All the following figures are in U.S. dollars.]

During the late 1990s Schering-Plough, along with Pfizer, was many portfolio managers' "big pharma" growth stock of choice, and in 1999 the firm's valuation peaked at $88 billion ($60 per share) to discount growth of around 15% per annum until 2008. The reason for this stellar valuation was that investors observed and extrapolated past successes: first, the growth in two company-developed proprietary drugs, Intron A — an "alpha interferon" for treatment for Hepatitis B, C and cancer; and Claritin — a non-sedating antihistamine with widespread applications.

(continued on next page)

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OID MAILBAG:
MARATHON — LONDON'S NICHOLAS SLEEP
(cont'd from preceding page)

It used to be clear sailing for Schering-Plough....

Sleep: The second reason was the extension of the economic life of Claritin through the company's innovative use of line extensions that focused on new delivery routes (syringes, tablets, lozenges, inhalers etc.) marketed directly at the consumer: Schering-Plough thinks of itself as the preeminent drug stock in this regard.

The effect was that its revenues doubled between 1994 and 1999 (with low product risk), its operating margins rose by 400 basis points and its operating cash flow nearly tripled. As capital spending remained almost unchanged, the company's free cash flow rose almost *four* fold.

SGP did nothing wrong. It just couldn't prove it....

Sleep: It was this latter metric that appears to have caused the company's downfall, as in May 2002 the FDA closed down the firm's Claritin factories for what it termed "compliance failures". In particular, the firm was unable to provide documentary evidence for each stage of the manufacturing process — although there was no suggestion that the quality of the product was faulty.

The firm has been fined $500 million and entered into a consent decree [which expires in] 2005. This came at a time when Claritin was finally coming off patent and prevented production of a Clarinex line extension.

When it rains, it pours....

Sleep: The generics have had a field day. During the second quarter of 2003 alone, revenues declined from $3.2 billion to $2.7 billion and cash flow halved. The timing could not have been worse. Next came an investigation by several states into the marketing and pricing of products. The investigation's turned criminal (the first criminal case in the sector) and may result in a fine of between $100 and $900 million according to various Wall Street estimates.

In the autumn of 2002, the SEC began an investigation into Schering-Plough's communications with investors following a meeting with a large mutual fund manager which presumably fell outside of Reg. FD. All of this has taken the share price down from $60 to $15.

HOW FAR OUT CAN ANALYSTS SEE?
LESS THAN THREE YEARS, APPARENTLY.

Under Fred Hassan, the turnaround begins....

Sleep: Richard Kogan, CEO and chairman since '98, resigned.... The successor's turned out to be Fred Hassan — formerly of American Home Products and then Pharmacia and Pfizer. Hassan's bias is to effect an operating turnaround with limited cost cutting rather than slash burn and sell.

Hope for a revenue-based turnaround comes in the form of Zetia which, when used in combination with statins such as Merck's Zocor, reduces cholesterol at a lower dosage than Zocor alone. A 50/50 joint venture's been established. But as Zocor does not come off patent until '06, Merck are in little hurry to cannibalize their own revenues just yet.

A one pill Zetia/Zocor combination is in the phase III clinical trials necessary to license a one-pill product and thus allow one insurance claim (and co-pay) as opposed to the current two.

It seems that 23 of 29 analysts can't look out three years.

Sleep: Unlike most pipeline drugs, the efficacy and demand for the Zetia/Zocor combination is already known. It's tried and tested and used today by those who can afford the cost of the extra co-pay pill. And the project would appear lower risk than the normal, jam-tomorrow pipeline drug. According to various Wall Street estimates, Schering-Plough's share of Zocor/Zetia earnings is expected to be about $800 million post tax in '07 — roughly double the current profits for all of Schering-Plough.

But despite acknowledging the probability of Zocor/Zetia earnings in '07, Wall Street isn't prepared to wait. Of the 29 analysts covering the firm, only six — none of whom work for the main stockbrokerage firms — think it's a buy. It appears that with a reasonable degree of certainty, attributable operating profits (note Zetia/Zocor is a joint venture) will be in the neighborhood of $2 billion in '07.

Schering's current price discounts no growth in cash flow.

Sleep: Whenever we value any business, we subtract maintenance capex, taxes and normalized interest costs and make assumptions for growth and its longevity and add back non-core assets and the value of fixed assets plus cash, net of liabilities. Assuming modest growth of 5-7% in '07 this would imply a value for the business of around $38 billion ($28 billion growth stock plus $10 billion in residual assets).

[Editor's note: Dividing by the 1.45 billion shares that *Value Line* expects Schering-Plough to have outstanding in 2007, that would be equivalent to about $26 per share....]

Sleep: As the market tends to discount near-term events in advance, this valuation may be achieved in '06 — which would imply an annual return of 20% per annum from Marathon's purchase price. In other words, the equity yield curve looks pretty steep.

Of course, Zetia/Zocor may not be a success, its launch may be delayed, it may cost more than anticipated to market or Pfizer may trump it with a better product. Despite this, as the current valuation of Schering-Plough discounts no growth in cash flow for the foreseeable future, the downside appears modest.

We didn't think we'd have the opportunity to own SGP.

Sleep: To conclude, despite our recent performance, we remain optimistic for future relative returns. The reason is that structural price anomalies persist in keeping with the theoretical insight provided by the equity yield curve concept described above. Indeed, as the average holding period of shares has declined, it is our opinion that long-term mispricing has become more widespread as investors allow their actions to be driven by false stimuli. Investment opportunities may not be in the same sectors as in 1999 and 2000, but the prospective returns, (i.e. the steepness of the "equity yield curve"), remain attractive.

Five years ago we would have thought it unlikely that we would own shares in Schering-Plough, but events have conspired to make the shares an attractive investment.

—OID

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Nomad Investment Partnership.

Annual Letter.
For the period ended December 31st, 2003.

There are two ways to present results: either in discrete annual increments or on a compounded basis. The former is industry standard, useful in demonstrating consistency of results (which your manager makes no pretence of being able to achieve), and for helping to assess outcomes for those that invested part way through. Our preferred route however is to be assessed on a compounded, multi-year basis for the reason that the only event we control is whether we are right, not when we are right. It is quite possible that our annual results will be inferior to the market for a period, but this will only convey information about the timing of outcomes, whilst saying little about the end result itself. We would therefore encourage you to be indifferent to the results below.

It may also be worth reiterating that the results have been achieved without leverage, shorting, contracts for difference, options, synthetic structures (LYONs, PRIDEs, LEAPs, MASTs - we are not making these names up) or financial exotica of any sort. If we ever write to you asking for permission to invest in any of the above, sell your shares. And call us to sell ours. Nomad is not a hedge fund, it is an Investment Partnership, and the results below have been achieved without the investment Viagras that have become so popular with the get-rich-quick-crowd. The results have been earned the old fashioned way, through contrarian stock picking.

With that in mind, the Nomad Investment Partnership and Nomad Investment Company Class A share gross results (i.e. net of management fees and costs, but before performance fees) for the last six months, trailing one and two years, as well as since inception are tabled below on a compounded basis, together with comparable results for a leading global stock market index (also see appendix):

To December 31st, 2003	Nomad Investment Partnership	MSCI World Index (net) US$
6 months	+42.5%	+19.8%
One year	+79.6	+33.1
Two years	+82.0	+6.6
Since inception (10/09/01)	+100.4	+10.5
Annualised since inception	+34.7	+4.4

For those investors that joined part way through, or are closet short-term oriented, the table below describes performance in increments (again, see appendix):

To December 31st, 2003:	Nomad Investment Partnership	MSCI World Index (net) US$
6 months	+42.5%	+19.8%
2003	+79.6	+33.1
2002	+1.3	-19.9
2001 (inception 10/09/01)	+10.1	+3.6

In previous letters we have tended to concentrate on describing some of the investments. In this letter we would like to change subject somewhat and describe some of the principles applied in managing the Partnership and explain its policies. These will be obvious to some of you and less clear to others but it is increasingly important that we all know where we stand as the Partnership grows in size.

Accounting for Performance

In his autobiography Charles Darwin made an uncharacteristic error: as a young man at Cambridge he recalled that,

"...My time was sadly wasted there, and worse than wasted. From my passion for shooting and for hunting, and, when I failed, for riding across country, I got into a sporting set, including some dissipated low-minded young men. We used often to dine together in the evening, though these dinners often included men of higher stamp, and we sometimes drank too much, with jolly singing and playing at cards afterwards. I know that I ought to feel ashamed of days and evenings thus spent, but as some of my friends were very pleasant, and we were all in the highest spirits, I cannot help looking back to these times with much pleasure".

However, in a footnote to the original text, Darwin's son, Francis, explains,

"I gather from some of my father's contemporaries that he has exaggerated the Bacchanalian nature of these parties".

Oh, dear! We all do that to some extent. It is at least comforting to know that even Darwin, a man whose great insights came from his ability not to fool himself, was capable of a little exaggeration. Perhaps he was just good at telling a story. At the inaugural Legg Mason Investor Conference Bill Miller, whose investment skills we much admire, confessed to analysing his mistakes more thoroughly than his successes. The latter he automatically presumed to have gone up for the very reason the shares were bought. As investors we all do this to some extent, winners flatter the ego regardless of the reason they went up, whilst we all feel bad about the losers. Several academic studies argue that mistakes hurt up to three times more than gains satisfy, a product of primordial environmental conditioning designed to prevent us from repeatedly eating poisonous food, apparently. For investors the implication of this asymmetry is great as it is often the favorable outcomes that drive performance more than losers destroy it. The Partnership's investment in Stagecoach has in effect

paid for the failure of Conseco six times over and yet it was Conseco that we wrote to you about first. These biases are very ingrained.

So, in this letter we will take Bill Miller's advice and start by attempting to explain why the Partnership has performed well, whilst trying as best we can to avoid Darwin's error of fooling oneself. The reason, of which we are certain, is the decline in the level of fear felt by other investors. We can analyse and quantify this phenomenon. Take the interest rate that the market demanded from Stagecoach Plc, a relatively cash generative and asset rich business. At the peak the cost of debt reached 15% per annum and in the last annual letter we explained that the Partnership had made an investment in the common equity and attempted, but curiously failed, to make an investment in the firm's public bonds. (Readers may recall that we failed in this regard as the company had cornered the market in its own undervalued bonds). Thirteen months later the bonds trade above par (investors are paying more than 100c on the dollar to receive 100c at a pre-defined date in the future, and interest in the meantime). What has changed opinions of this firm in such a short period? The answer lies in the huge levels of free cash flow that has followed the decline in capital spending, restructuring and asset sales. By changing strategy and capital allocation on a six-pence the balance sheet has been repaired, the business shrunk to its cash cow operations and the market now anticipates, with almost 100% probability of outcome that the bonds will be repaid. Indeed the firm's standing is so good today as to be able to borrow money at a slight premium to the UK government and the share price at the time of writing has risen six fold from our original purchase price.

This sea change in company behaviour is not limited to Stagecoach. The Partnership's investments in Primedia, Xerox, New World Development, Schibsted, Lucent, Georgica, Hong Kong and Shanghai Hotels, Telewest, BIL International, Jardine Strategic and Kersaf can all be described in this way (even after the sale of Lucent Preferred shares, that's over 40% of Partnership assets). According to Empirical Research Partners, an independent research boutique in New York, in 2003 the ratio of capital spending to revenues at US companies was at its lowest level since at least 1965 and free cash flow the highest compared to market capitalisation. The predominance of free cash flow has allowed market interest rates charged to the most indebted businesses (the so called junk bond spread), the highest for a generation between the end of 1999 and 2003, to decline to more normalised levels and it is the shares of businesses perceived to be in the worst condition that have bounced the most. Nomad has been heavily concentrated in this category.

So performance to date has been a product of investments made in the most despised businesses, where temporary issues have depressed prices. We hope to be able to report that fact to you in most letters, although the names of the companies and circumstances will no doubt change. Over the coming years, although less so in the short term, it is possible that the other half of our portfolio, the higher quality portion, will contribute the most to performance. It is possible also that some of our successful turnarounds may find themselves in this higher quality category if current management behaviour is sustained. We travel hopefully in this regard.

A Typical Purchase, Expected Returns and Portfolio Management

An index has been included along with results at the beginning of this letter, not for the purpose of explicit benchmarking but in order to place performance in context. Nomad is an absolute return Partnership, which raises the question: what returns are we trying to achieve? At this point regular readers may feel that in trying to discuss prospective returns we are skiing off-piste. However, we would rather expectations were sensible rather than risk any mental extrapolation of historic results. To help illustrate the returns we aim to achieve, it may be helpful to explain what we are thinking when we buy a share.

Our aim is to make investments at prices we consider to be fifty cents on the dollar of what a typical firm is worth. Capital allocation by investee companies must be consistent with value creation and, if this is the case, we expect that the real value of the business (the 100 cents value) could grow at around 10% per annum. The effect over five years will be to compound U$1 of value into U$1.62, and companies that can build value like this are normally rewarded in the market with a fair valuation (i.e. are priced close to U$1.62). This happy outcome would imply a return from purchase price (50 cents) of around 26% per annum. So what happens when we are wrong? Our most common mistake is to misjudge capital allocation decisions by our companies: firms which articulate a share repurchase/debt repayment strategy and have incentives to reinforce that outcome, throw caution to the wind and make acquisitions instead. The Partnership's investment in Readers Digest falls into this category. Capital allocation mistakes such as these often prevent the compounding of value but to date have rarely resulted in a permanent decline in the share price to below our purchase price (50 cents). We have therefore tended to find that our mistakes atrophy (stay cheap) rather than collapse, although we can all name one collapse!

If over five years our mistakes are on aggregate flat, and our mistakes total half of Partnership assets, then this implies a compounded annual return of 13% for the portfolio as a whole[3]. Not each year, and maybe not for several consecutive years, but over time this level of expectations appears reasonable to us. This model is daftly precise, a little too neat and the one thing we can almost guarantee is that returns will not be exactly 13%. It is important however that we all understand the investment process and time frames involved.

The prime determinants of outcome are price (sticking to 50 cents on the dollar) and capital allocation by management. The first is in our control, that is, it is in our control to be patient and wait for the right price. The second involves a subjective judgment about the quality of management, and an assessment about the sustainability of business returns in the long run. It is these factors that occupy almost all our time.

One Partner confessed to us that his wife viewed Nomad gains as jewelry in waiting and wanted to know what advice could we give him to delay the shopping spree? We offer no advice here, but lay out some simple facts. Today, your manager's job is to

[3] Marathon Counsel: This is a hypothetical illustration only based on the assumptions set out above and is neither an indication or guarantee of the actual performance of the Partnership nor is it intended to form part of the investment objective of the Partnership.

reinvest the successful investments (dollar bills) back into more companies trading at half price. At the time of writing our internal calculation of the price to value ratio of the Partnership is 65 cents on the dollar, approximately the same as at the end of June despite fund performance. We have done this through investing incremental funding into new companies such as New World Development, Telewest, Midland Realty, and UnitedGlobal Communications, and through the sale of the Lucent Preferred shares (at above par value), the partial sale of Stagecoach and the pending sale of Weetabix (more later on this investment). Rest assured, nothing occupies your manager more than reducing the price to value ratio of the Partnership, as we believe this to be the best indicator of latent value and future performance. In the interests of fair disclosure Warren Buffett was asked a similar, jewelry-related question at the 2002 annual general meeting of shareholders of Berkshire Hathaway to which he replied with a grin that in his experience he had never been disappointed by what had happened after he bought the jewelry.

Partnership Growth

At the time of writing the Partnership is nearly five times bigger than at inception, with the smallest contribution having come from investment performance! The balance is due to subscriptions made by new and existing investors. These contributions have been welcome from the viewpoint of making Nomad a viable commercial activity, but it has only been appropriate to accept subscriptions as we have been able to put incremental capital to good use. It is only fair to report that due to a quirk in your manager's character, growth in assets from this source drives him mad. The reason is the dilutive effect it has on overall performance. Take for example our investment in Resorts World, a Malaysian casino. At the time of purchase the holding was 5% of assets and yet despite the shares doubling in the last two years the holding today is smaller as a proportion of the Partnership than two years ago. Likewise Kersaf and Television Broadcast, whilst Stagecoach would have peaked at around 25% of fund assets, but peaked at 15% due to dilution. So what is to be done?

There are three alternatives:

1. Accept subscriptions as they come and place cash on deposit until suitable investments can be found. The problem here is that money can easily arrive faster than good investments, almost inevitably so, with dilutive consequences for existing investors, and suboptimal outcomes for new investors.
2. Accept subscriptions as they come and buy a little of everything to replicate the existing portfolio. This sounds attractive as, dealing costs and liquidity constraints aside, prospective returns from the Partnership as a whole are broadly maintained. But it does have one major, subtle drawback. There are very few absolutes in investing, but one thing about which we can be certain is that as prices rise prospective returns go down. If a business is worth U$40, the purchase of shares at U$30 has to be inferior to their purchase at U$20. We expend a great deal of mental effort preserving the integrity of our purchase decisions and would rather not have the thinking muddied by purchases made at ever-higher prices due to subscriptions. In our opinion, this alternative risks devolving the initial investment decision back to the subscribing party, who are likely-as-not unaware of their additional role as stock picker.

3. Match subscriptions to new ideas with a right to draw down or defer subscriptions as necessary. In our opinion this is the superior strategy as incremental funding is invested in new fifty cent dollars, thereby lowering the price to value ratio of the fund and with the effect that new investors bring something to the party. We have guestimated that we may be able to find incremental investments at the rate of one per month. This is a best guess on our part and if pushed we will concede that it looks high; ideas may be far less frequent than that. New holdings average 5% of Partnership assets at purchase, a fact that dictates incremental funding is limited to around 5% of assets per month.

Route 3 is the most equitable way to run the Partnership in our opinion but does require patience on the part of new investors whose subscriptions may need to be staggered over several quarters. Even so we have been surprised by the support this eccentric regime has received. The largest non-Marathon investor in the Partnership noted that one of the reasons they chose to invest was precisely because of the emphasis placed on performance over asset gathering. This investor then offered to pro-rata their subscription should we request, in effect extending their subscription period to make way for other co-investors. Such courtesy is exceptional in this industry but captures the spirit in which we are trying to run the Partnership. Bravo! We have no interest in diluting the quality of our Partners from what we believe to be a very high level.

Partnership Closure

Our preferred state of affairs is to close and for growth in assets to be investment-led. We will close when any of the following conditions are reached: it is no longer possible to invest a unit size; time spent marketing rises above a very low level, say 1% of the working year; or when we feel the quality of the client base is being diluted. In all likelihood this means closure when the Partnership is still small by industry standards and we are very comfortable with that.

Weetabix

Many of you will have read that Hicks, Muse, Tate and Furst Inc., a private equity firm, bid £53.75 for each Weetabix share at the end of last year. We have received several e-mails from Partners offering congratulations. As detailed in the June 2002 Partnership letter your broadminded approach to investing and approval of the amendment to the investment objectives facilitated this investment and so you too should be congratulated. Freud might conclude that that is why the e-mails were sent. However, may we caution against euphoria?

Take the structure of the transaction, which is a Scheme of Arrangement rather than General Offer. The threshold of approval under a Scheme of Arrangement is 75% of the shareholders rather than 90% in the case of a General Offer. Proponents favour the lower threshold as it makes it harder for minority shareholders to block the transaction – but why be so defensive? The George family have signed irrevocable undertakings to sell to Hicks, Muse which would only be broken in the event of a bid at greater than a 25% premium to the Hicks, Muse offer. Why are the irrevocables necessary if the business has been properly auctioned, as the bankers claim? The family and board

have a deal that is not available to shareholders through their continued employment with the firm post sale. It strikes us as odd that the highest bid for the company should come from a private equity firm who have an eye on selling the business at a profit, rather than a natural competitor who would enjoy the benefits of removing duplicate costs over many years. All this reinforces the notion that the price is low, in our opinion by around 25%, and note that Hicks, Muse will no doubt feel they have a good deal too.

We have written to Sir Richard George, Weetabix's Chairman, met the investment bankers who purportedly represent our interests, listened to their responses and voted against the deal. This is a cry in the dark, as even the largest non-family shareholder publically supports the deal. Our shareholding is too small to make a difference to the outcome and although our preference is to retain the shares, in private unlisted form alongside Hicks, Muse, that option is not available under a Scheme of Arrangement and the Court will require us to sell our shares.

The Weetabix offer is only one of many privatisations of cheap, small and mid capitalisation businesses in the UK. Institutional shareholders have abandoned these firms in favor of mega-caps, and the shareholder base is left dominated by one or two inside interests and a tail of small holders. Our view is that the discount that the shares trade at in the market is an asset to be harvested for the benefit of all shareholders through share repurchase. But human nature being as it is, insiders will be incented by the low valuation to buy the shares for themselves. A Scheme of Arrangement is the most ruthless method of asserting one party's will over a fragmented and non-professional shareholder base, and coupled with irrevocable acceptances allows take over offers to be presented as a *fait accompli* to shareholders. Please note: bad practice spreads. Despite this, and the almost daily occurrence of privatization proposals in the UK, there has been almost no criticism by shareholders, the authorities or in the media. In no other sphere of capitalism can your property be seized in exchange for cents on the dollar (except compulsory purchase on the grounds of national interest). But fund managers, who in their private capacity would be insulted if someone offered less than their house was worth, happily sell shares in their professional capacity at discounted prices to smart buyers. And no one cries foul.

The indifference shown by those in positions of influence reminds us of Horatio Nelson who, when ordered by semaphore to withdraw from the Battle of Copenhagen, placed a spyglass to his blind eye and said, "I really do not see the signal!" Whilst we have a profit on our investment in Weetabix, shareholders should be careful what they wish for. Before congratulations are in order, Partners need to weigh in their minds short-term profits against value forgone in the discounted offer price and the incentive provided by the success of seizure for potentially more of the same in the future.

So what is to be done? The best defense is to own enough of the company to influence the outcome. In most cases in excess of 10% of the shares outstanding would suffice. Those that advocate market liquidity of their investments over other considerations might like to bear in mind an investor's inability to influence outcomes whilst owning a deminimus proportion of a company. Should Nomad continue to grow in size, we intend not to make this mistake.

Housekeeping and a reminder on the Need for Patience

You can expect from us an annual and interim letter (this is our third annual letter) and Global Investment Reviews eight times a year in which we discuss our investment thoughts. In our opinion these documents, once digested, provide the information needed to form a judgement about what and how we are doing. From Nomad's administrator (Daiwa Securities Trust and Banking, +353 1603 9921 for your inquires) you can expect a monthly statement of your account and annual and interim financial statements. Do call them if you are not receiving all you should. Nomad's orientation is genuinely long-term, and more regular reports, daily, weekly, monthly or otherwise, are likely to be of little value to you, and may even be counterproductive.

One of Nomad's key competitive advantages will be the aggregate patience of its Partners. We are genuinely investing for the long-term, in undervalued firms run by management teams who may be making decisions, the fruits of which may not be apparent for several years to come. In the near term our results are as likely to be bad as good, but we are confident that in the long run they will prove satisfactory. If Nomad is to have a sustainable comparative advantage this will come from the capital allocation skills of your manager and the patience of our Partners. In the latter we have started well, with no Partner turnover since we began and almost no enquires into performance despite the swings in general market prices. This is very unusual and a huge credit to our Partners, and implies a similar long-term outlook. Only by looking further out than the short-term crowd can we expect to beat them. It is for this reason we named Nomad an Investment Partnership and not a fund (and certainly not a hedge fund!). The relationship we seek is quite different.

As always we thank you for your confidence and value your support.

Yours sincerely

Nicholas Sleep

Nomad Investment Partnership.

Interim Report
For the period ended June 30th, 2003.

The Nomad Investment Partnership and Nomad Investment Company Class A share gross results (i.e. net of management fees and costs, but before performance fees) since the end of December 2002, the end of December 2001, as well as since inception are tabled below, together with comparable results for a leading global stock market index:

To June 30th, 2003:	Nomad Investment Partnership	MSCI World Index (net) US$
From: December 31st 2002	+26.0%	+11.1%
December 31st 2001	+27.7%	-11.0%
Since inception (10/09/01)	+40.6%	-7.8%
Annualised since inception	+20.4%	-4.3%

In January we sought permission to change Nomad's investment policy to include unlisted equity and in February the proposal was unanimously approved and the policy changed. This permitted a sizeable investment in Weetabix Limited, a manufacturer of breakfast cereals and bars in the UK. Your prompt response permitted investment whilst the price was particularly depressed with the effect that the Partnership has a 20% profit compared to purchase price. This gain was in part a product of the speed of the Partners' collective response and the administrative process, neither of which is under your manager's control. So thank you and well done. You may even want to discount the results above for the Weetabix gain (but don't ask for a rebate on fees!). We shall return to Weetabix later in this letter.

In December's annual letter to Partners we wrote:

"During the late summer and autumn, when investors were at their most depressed we made several new investments and in some cases added to existing holdings. Although time will tell, this period may mark the end of investors' mood swing from euphoric at the turn of the millennium to manic depressive almost three years later…We also feel that there are many undervalued investments available to us, to which we could put incremental capital to work. You can expect us to caution you when the opposite is true and we find little available at reasonable prices. But for now, for those with a long time horizon, we think it is a good time to be making investments".

That seems to have been the case, but for the record, and in case there is any misunderstanding, we do not have the faintest idea what share prices will do in the short term - nor do we think it is important for the long-term investor. All that we observed in the autumn was that barring a catastrophe, indeed in some cases perhaps even including a catastrophe, prices were so low that long-term success was almost inevitable. Even though these are still early days, the Partnership now enjoys a 52% advantage over the investment averages, as presented by the MSCI World Index (for mathematicians the calculation is (((1+0.406)/(1-0.078))-1)x100)! This is a reasonable absolute gain, and large relative gain over a short period of time, so may we provide some simple philosophy and maths as guidance in how to think about results so far?

We were rather struck by some of the early Buffett Partnership letters in which Warren Buffett offers the following advice: return for a moment to the table above *"and shuffle the years around and the compounded result will stay the same. If the next four years are going to involve, say, a +40%, -30%, +10%, -6%, the order in which they fall is completely unimportant for our purposes as long as we all are around at the end of the four years",* as we, at Marathon, intend to be. *"The course of the market will determine, to a great degree, <u>when</u> we will be right"* (the sequence of annual outcomes), *"but the accuracy of our analysis of the company will largely determine <u>whether</u> we will be right. In other words, we tend to concentrate on what should happen"* rather than when it may occur.

Our preference is for results to be measured over a five-year time frame, and even this may be a little short compared to the average holding period of the underlying investments which is presently around ten years (inflated by a dearth of sales). In this context the short-term results remain just that, short-term, and you should be as indifferent toward results so far as the annual sequence in which they have occurred. A stoical disposition to short-term results is both the right way to think (never mark emotions to market) but it also prepares one for results that may be reasonable, but are unlikely to be an extrapolation of the last two years.

Indeed future results are almost certain to be different. The index is unlikely to continue to decline, and even though absolute returns may be favorable, our advantage over the index will in all likelihood erode somewhat. We are prepared for this and are recycling shares that have performed well (in aggregate the portfolio is valued at around 65c on the dollar of intrinsic value, up from 50 cents in December) into new fifty-cent dollars.

We are always on the lookout for companies with corporate character that are pursuing strategies designed to create sustainable value. This is no mean feat, and we work hard reading annual reports and proxy statements and interviewing management trying to answer the questions: what are returns on incremental capital and the longevity of those returns?, are management correctly incented to allocate capital appropriately?, and what is discounted by prices? Once these businesses are found they can be multiyear winners provided capital allocation remains consistent with value creation. All too often however management become sidetracked and misallocate capital usually through diversification or in the words of Peter Lynch, "diworsification". The result of which is that aggregate returns on capital decline and the share price falls to discount poor performance. Quality of managerial character is therefore important to avoid capital misallocation and it is in the search for such character that we asked an investment bank to perform a simple company search earlier this year (the first search this manager has employed in twelve years).

The criterion was for companies with no increase or decrease in shares outstanding in the last ten years. This simple screen it was hoped would yield companies that had resisted the fashions for share repurchase, stock options and share issuance to fund growth. In short it was hoped that the search would lead us to firms that had not allowed the bubble to affect the way they operated their businesses. We knew of two companies that would make the list (Fastenal and Wesco Financial) but were amazed that there were just five others in the US with a market cap above U$50m. One of these was Erie Family Life, the life insurance subsidiary of the Erie Indemnity Company founded by H.O. Hirt in the 1920s. Management kindly obliged us with requests for an interview and when we explained why we thought the business may be of interest the response came,

"Hell, we have not issued a share since 1925!!!"

There are not many companies like that. In a similar vein we stumbled across Hershey Creamery, another business with reasonable economics, a low valuation and seemingly stubborn resistance to outside influence. So stubborn in fact that we found it difficult to obtain annual reports or proxy statements, and resorted to asking the CFO for a copy only to be told "these are mailed out to our shareholders". How then might a potential investor form a judgment whether they would like to become a shareholder without the benefit of an annual report?

"It's a common complaint", came the reply.

This analytical Catch 22 may not be helpful, but it does reveal that some firms remain resolutely independent of mind, despite the twenty-year bull market that has raged around them. As if to prove Groucho Marx right ("I do not care to belong to any club that would accept me as a member"), we have not given up on Hershey Creamery yet, if only to satisfy our curiosity.

Per share discipline is much misunderstood by investors. The long-term rate of share issuance in the US is over three percent per annum, comparable to the trend growth in

the economy and far exceeding population growth. And whilst it can be argued that something is normally being bought with the shares issued, it is also true that some items, such as incentive compensation, have a shorter shelf life than newly issued shares that may remain outstanding forever. Buying transitory outcomes (e.g. a manager with a one year employment contract) with permanent capital is a duration mismatch a bond investor might understand, but short-term equity investors care little about, and so the dripping tap of share issuance is rarely turned off.

There are two ways to tackle this phenomenon: first is to be a beneficiary of share issuance, usually through other investment liabilities such as bonds or redeemable preferred stock, witness Nomad's investment in Lucent 8% Preferreds (more later). Second is to be an owner of a business capable of compounding value from a static share base, such as Weetabix. What is required is an understanding and mandate to invest across the capital structure (bonds and equities).

The modern investment management industry generally lacks this ability. The system has become rules-based and managers straight-jacketed into geography, sector, style, market capitalisation or security type specific mandates (this list is not exhaustive). These managers are unable to purchase investments outside these narrow constraints, regardless of the case for doing so. H.O. Hirt, the founder of Erie Indemnity, posted the following notice to staff:

"RULES
Are for INFANTS**, INCOMPETENTS,**
INCARCERATED CRIMINALS and **IMBECILES**
- NONE of WHOM should have any place in
the **ERIE FAMILY."**

Source: "In His Own Words" by H.O. Hirt, original emphasis.

We would not go quite as far as H.O., but when it comes to the modern fund management industry he is on the right lines. At Nomad we have as broad an investment mandate as possible, which has allowed us to make investments as diverse as the preferred shares of a US technology business (Lucent), the common equity of a Scandinavian newspaper business (Schibsted), unlisted UK equity (Weetabix), a small capitalisation Thai newspaper (Matichon), a South African casino (Kersaf), a Hong Kong mobile phone operator (Smartone) and even a large US discount retailer (Costco). This breadth of scope is why we named the Partnership "Nomad".

The point is that there are more tools in Nomad's box than are available to most fund managers and to help illustrate the point we would like to describe investments in Weetabix and Lucent 8% Redeemable Convertible Preferred stock. Nomad may be unique in the industry in having both investments in one portfolio.

Weetabix was established by the George family in 1932 as Britain's answer to the growing popularity of imported cereals, notably from the Kellogg Company. The firm was initially capitalised by the family and, as may have been common at the time, by

a group of local farmers to secure their supply of commodities. The company has required no further equity capital and the share count is essentially unchanged since the 1930s although some farmers have chosen to sell their shares and it is these that form the free float that trades on Ofex. Weetabix manufactures and markets Weetabix, Alpen, Ready Brek and Weetos and has a total market share of around 22% of UK breakfast cereals. The company spends heavily behind its brands through advertising and marketing, a cost the Chairman refers to as "investment in the future". This has been in contrast to some of Weetabix's competitors who have cut spending in order to meet Wall Street's short-term earnings expectations. The effect is that Weetabix's share of voice (share of industry marketing spend) has exceeded the firm's share of market. For a consumer goods company this is often a powerful combination, as market share tends to rise or fall in the direction of share of voice. The high marketing spend also has the effect of creating a direct relationship with the customer which retailers find hard to break. In a recent test of the strength of the franchise a large UK supermarket suspended Weetabix in favour of own branded goods only to change their minds after disappointing own-brand sales and resume stocking Weetabix cereals. We particularly enjoyed this Weetabix advert run in the 1940s that could be applied to the firm's negotiating stance with retailers today.



Source: Weetabix Limited.

The firm does not skip on capex either and runs its factories with fifty percent capacity redundancy in an effort to maintain standards of production and delivery reliability. This belt and braces approach lowers short-term returns on capital, something the City would also frown upon, but builds the reputation of the firm in the long-run. Value creation is often most sustainable when it is built slowly, and notably last year Weetabix became the largest selling breakfast cereal, overtaking Corn Flakes seventy years after the company's foundation.

The investment case is sealed, as the shares are ludicrously cheap. If one assumes modest levels of growth in free cash flow as the advertising spend bears fruit then the firm might be worth around £70 per share compared to Nomad's purchase price

around £20. In a rare indiscretion, Sir Richard George, Chairman, let slip that on his death a search of his wallet will reveal a multitude of rejected offers for the business over the last thirty years from a host of international food groups. And what might these prices be? At the price PepsiCo paid for Quaker Oats (ex Gatorade) or Hershey was bid for more recently, the implied private market value of Weetabix is around £75 per share. Both valuations are depressed by the weight of cash on the balance sheet, which amounts to £5 per share, and ignores the value of property, which is in the books at 1988 prices.

So the real issue is, why is the business so cheap? The answer may be found in the firm's listing status, that is to say it does not have one, as the firm's shares trade on Ofex (similar to the pink sheets in the US) rather than on the London Stock Exchange. Big institutions are often not permitted by their mandates to invest via Ofex, and the shares remain relatively illiquid and the market capitalisation modest, further depressing City interest. And whilst the free float may have been an accident of history, management do care enough about the share price to have included it as a component of incentive compensation. In other words, Weetabix is just our sort of company.

In the autumn of 2002 Nomad purchased a sizeable investment in 8% Redeemable, Convertible Preferred stock issued by Lucent Technologies. The prefs, purchased for U$350 per share, are an unusual security as they can be put back to the company at par (U$1,000 per share) in August 2004 for payment in cash or a variable number of common shares. As at the time the market capitalisation of the firm was so low, the put risked (from a common equity holder's perspective) delivering half of the common shares to the pref holders if the share price failed to rise. The put also made the prefs the first of Lucent's fixed liabilities to come due (so they were at the top of management's to do list) and just as important pref holders would receive almost half of their investment back through cumulative dividends before the put became due! In effect, one half of Lucent's proforma common equity could be purchased for U$500m (the market value of the prefs) a figure equivalent to only a few months' research and development spending. The capital markets had all but given up on the company even though they had enough cash on deposit to redeem the prefs and all outstanding debt entirely.

The investment controversy was how would management respond to the dire prognosis delivered by the market? Management presented two choices: (a) continue as before and hope that operating cash flow would turn positive with further cost savings and perhaps an upturn in orders. This had been management's preferred route since the bubble burst. Or (b) dilute the existing shareholders whose investment had already fallen 98% from the peak three years earlier and issue more equity to fund redemption of the prefs. Management's assessment might have been something like Woody Allen's prognosis:

"More than any time in history mankind is at a crossroads. One path leads to despair and utter hopelessness, the other to total extinction. Let us pray we have the wisdom to choose correctly".

But there was a third choice which, as common shareholders, Marathon was urging the company to pursue: (c) conclude the market was wrong, and buy back the prefs and common shares and repay debt with cash on hand and return the firm to an un-leveraged balance sheet. This would have preserved the upside for existing common shareholders and restored value for the pref holders but would have left management without a cash cushion, but this, we argued, could be restored through a rights issue if necessary. Management chose (b) the sleep-at-night choice. In short, management marked their emotions and the company's balance sheet to market at the weakest point in the cycle, and although time will tell this is likely to be a huge source of value foregone for the common equity holder. For the pref holders issuance of new common shares has provided the resources to meet the put (which is now covered many times with cash on hand) and the prefs have risen three fold to trade at a premium to par, as the 8% yield is deemed attractive by fixed income investors. The investment has reached full value and will be sold as new investments become available.

Our results to date place Nomad at or very near the top of any investment fund league table over the same time period, regardless of whether the opposition employed leverage, options, shorting or the such like – again, we employ none of these techniques. The effect is that, in all likelihood, Nomad's funds could be grown quite rapidly if we allowed the floodgates to open and take all comers. This we will not do. We have only one chance to grow Nomad to a reasonable size before it is closed, and the quality of investors when the doors are shut is of great importance to us. To date, we have declined almost as many investment dollars as we have let in, a ratio that the industry does not track and a habit that the industry is not good at keeping. But even so, whilst we hope that the fund will grow over time, we are in no hurry to do so, and will endeavor to maintain the quality of the Partners with whom we will share results, bad and good.

May we finish with the usual reminder of housekeeping issues and a final word on the need for patience? Several investors are new to the fund and so it may be worth reiterating some ground rules so that we all know where we stand. You can expect from us an annual and interim letter (this is our second interim letter), and Global Investment Reviews eight times a year in which we discuss our investment thoughts. In our opinion these documents, once digested, provide the information needed to form a judgement about what and how we are doing. From Nomad's administrator (Daiwa Securities Trust and Banking, +353 1603 9921 for your inquires) you can expect a monthly statement of your account and annual and interim financial statements. Nomad's orientation is genuinely long-term, and more regular reports, daily, weekly, monthly or otherwise, are likely to be of little value to you, and may even be counterproductive.

One of Nomad's key competitive advantages will be the aggregate patience of its Partners. We are genuinely investing for the long-term, in undervalued firms run by management teams who may be making decisions the fruits of which may not be apparent for several years to come. In the near term our results are as likely to be bad as good, but we are confident that in the long run they will prove satisfactory. If Nomad is to have a sustainable comparative advantage this will come from the capital allocation skills of your manager and the patience of our Partners. In the latter we have started well, with no Partner turnover since we began and almost no enquires

into performance despite the general decline in market prices. This is very unusual and a huge credit to our Partners, and implies a similar long-term outlook. Only by looking further out than the short-term crowd can we expect to beat them. It is for this reason we named Nomad an Investment Partnership and not a fund. The relationship we seek is quite different.

As always we thank you for your confidence and value your support.

Yours sincerely

Nicholas Sleep.

Nomad Investment Partnership.

Year End Report
For the period ended December 31st, 2002.

The Nomad Investment Partnership's gross results for the six and twelve months to December 2002 as well as since inception are shown below, together with comparable results for a leading global stockmarket index:

To December 31st, 2002:	Nomad Investment Partnership	MSCI World Index US$
6 months	-2.59%	-11.97%
One year	+1.30%	-19.54%
Since inception (10/09/01)	+11.57%	-16.28%

It is never rewarding to report on a period when the market price of your investment in the Partnership has declined, as it has in the last six months. Nor do we derive much pleasure from pointing out that the alternatives presented by the leading stock market indices have fared much worse, but as we stated in the interim letter published in July, "in weak or flat markets you should be expecting us to do relatively well".

It is almost certain however, that over any time frame the investment performance of the Partnership will only approximate the change in the real value of our companies, and even then it may be only a very general approximation. Some years our investment performance will exceed growth in the value of our businesses, in others the reverse may be true, as we believe to have been the case in 2002 and shall discuss in more detail in this letter.

It is worth noting also that the Partnership results have been achieved without leverage, shorting or financial derivatives of any kind, nor do we wish to employ such techniques. Rather our results have been achieved the old fashioned way, through buying securities in reasonable businesses at discounted prices. It may be instructive perhaps that these old techniques, though deeply unfashionable in modern financial circles, work just fine. For example our results include the demise of Conseco, which

filed for Chapter 11 bankruptcy protection in December. We have retained our shares in the company and you will find them included in the statement of investments at the end of this letter although we expect them to be all but worthless. Investment mistakes are inevitable and indeed to some extent desirable, and we have no interest in hiding them from you (or in portfolio window dressing) - as they say, it is what it is. A full Conseco mea culpa was published in September's Global Investment Review (Volume 16, No.6). All that said, we derive little pleasure, to say nothing of performance fees, from earning the equivalent of money market rates whilst investing in the equity market. It is absolute returns that we are after, and on this score our results since inception are only fair.

During the late summer and autumn, when investors were at their most depressed we made several new investments and in some cases added to existing holdings. Although time will tell, this period may mark the end of investors' mood swing from euphoric at the turn of the millennium to manic depressive almost three years later. Anecdotal evidence suggests that investors are not thinking straight. Take for example recent events at one of our UK investments, Georgica Plc. One day in early November the company issued a press release which began as follows:

"Georgica Plc has today noted that an administrator has been appointed to Riley Leisure Limited. Georgica wishes to emphasize that Riley Leisure limited is not a member of the Georgica group although Georgica's Cue Sports businesses do trade under the name Riley's".

That announcement did not stop the share price from declining over 6% that day. Presumably somebody, somewhere had decided that the company now in administration was owned by Georgica and without checking, hurriedly sold their shares. Nervous investors tend to shoot first and ask questions later. As the saying goes, act in haste - repent at leisure. We were particularly heartened that Georgica resumed its share repurchase program the following week. A cool head under pressure is what is required.

The result of our recent purchases is that cash as a proportion of the overall fund has been reduced from over 20% during the summer to around 5%, with much of the remaining balance ear-marked for an investment we would like to describe in our next letter, that is when we have finished acquiring our shares. (Discretion whilst investing is normally an advantage.) This means that in effect we are close to fully invested. We also feel that there are many undervalued investments available to us, to which we could put incremental capital to work. You can expect us to caution you when the opposite is true and we find little available at reasonable prices. But for now, for those with a long time horizon, we think it is a good time to be making investments.

After our recent purchases the characteristics of the Partnership are as follows: 41% of assets are invested in "difficult to copy" franchises such as TV stations, newspapers, magazines or a motor-racing track; 31% of the fund is invested in asset backed businesses such as hotels, casinos, conglomerates or those companies where balance sheet cash forms a large portion of the current valuation; and finally 22% of the fund is invested in deep value work outs where profitability is temporarily depressed, and where the firm has sizeable amounts of debt. In aggregate these investments are priced in the market at around 50% of what we believe the businesses

to be worth, that is to say be believe we have bought dollar bills for around fifty cents. It is worth noting also that nearly half of our companies (by number, more by value) are buying back debt or repurchasing shares and at two thirds of our firms there has been notable insider buying. At one third of our investments there has been both insider buying and debt or equity repurchase.

Nomad has as broad an investment mandate as we could imagine. We can for example buy common shares, preferred shares, debt or convertible bonds. In analysing a company we assess the merits of investing in all levels of the capital structure but to date we have concluded that the common and preferred shares have been the more attractive investments. We have however attempted to buy the bonds of two companies which were trading at large, and in our opinion unwarranted, discounts to face value. How does one attempt, but fail, to buy a bond? One way is for the company to be more aggressive in bidding for the bonds than we were. Indeed it appears in one case that the company, as part of a debt repurchase program, may have had a standing order with all the market makers on Wall Street to buy any of its bonds that were offered and to let none remain in the hands of third parties. This might seem unfair, but management score highly for gusto, and their equity holders, of which Nomad is one, should applaud such actions. In the light of the record credit spreads available in the US and widespread investor irrationality this is exactly how we want our company management to behave. A cool head under pressure once again.

Some final requested statistics to help describe the characteristics of the fund: the Partnership is invested in twenty-five companies from eight countries. Bloomberg classify these in twenty two different industries although their industry definitions are rather narrow. In our opinion there remain notable concentrations in publishing, broadcasting and media (27% of partnership assets); hotels, casinos and real estate (23%); consumer goods and retailers (18%); and telephony, cable and equipment suppliers (12%). There are also holdings in transport (9%) and office automation and information services (6%), with a now diminished balance in cash. Geographically the distribution is as follows: US 41%, Hong Kong 14%, UK 12%, Thailand 9%, South Africa 6%, Malaysia 5%, and Norway and Singapore 4% each.

In previous letters and Global Investment Reviews we have discussed the investment case for Saks, International Speedway, Matichon, Xerox, Hong Kong and Shanghai Hotels, Conseco (augh!), Kersaf, and one of our sales Monsanto. That's approximately 30% of the portfolio covered. This time I would like to discuss our investment in Stagecoach (8.6% of Partnership assets) and Costco Wholesale (3.1% of Partnership assets).

Stagecoach is the largest bus operating company in the UK, operates the commuter train services from London's Waterloo station, and bus services in Scandinavia, Hong Kong, New Zealand and the US. The firm was listed in London when shares were sold to the public at 20p in 1993. In the early 1990s and after years of national ownership, the UK bus system was deregulated with the right to operate services, depots and buses sold in auction to private companies such as Stagecoach. The system was ripe for an overhaul, buses were poorly time-tabled and run for the convenience of the driver and conductor rather than the passengers and fares irregularly collected. Brian Souter, Stagecoach's entrepreneurial and straight-talking CEO, started his career as a bus conductor and was good at doing the simple things right, such as

collecting fares, putting on more buses during the rush hour, handing out mugs and flags to passengers on new services, painting buses bright colours and most of all undercutting the remaining state owned competition. Bus deregulation proved to be a huge success in the UK as passenger numbers grew, and was copied abroad with the result that Stagecoach had a natural advantage exporting its brand of deregulated bus services. By 1996 as the firm developed businesses in Scandinavia, Hong Kong and parts of Africa, and within ten years of listing revenues and profits grew ten-fold and the share price reached a peak of £2.85 in 1998. One City research note struggled with the price of the shares at the time but concluded a "Souter premium" might be appropriate! Souter went into semi-retirement in the late 1990s as one of the richest men in Britain and handed day to day operations to the next generation of management, apparently leaving them with instruction to maintain the dividend.

It was about the same time that the problems started. It was no secret that running buses could be a reasonable business and as deregulation spread bus companies from around the world wanted to be running bus operations elsewhere and the price of franchises rose. A similar pattern has followed the deregulation of US utilities and telephone services in the late 1990s. Stagecoach began looking for growth elsewhere, and purchased a minority stake in a Chinese toll road operator, and control of a train leasing business which it sold shortly afterwards. However, the big mistake came with the hubristic top-of-the-cycle purchase of Coach USA, itself a debt funded roll-up of several disparate bus, taxi and charter coach operations which had been assembled by investment bankers and a leveraged buy out (LBO) fund. The price paid was too high, the operations had little economic merit on their own, let alone bundled together, and the acquisition had been debt funded. In short the company had geared up to buy a company worth a fraction of the purchase price. It then got worse. Improving the operations of Coach USA required a heavy investment program (thank you, LBO fund) at the same time as the firm had committed to renew the UK bus fleet. The US operations were quite unlike the simple time-tabled commuter bus operations the firm had operated in the UK, and required more management time, to the detriment of the UK business, which was ignored and began to flag. It is not hard to run a profitable bus company "but you do need to keep the plates spinning [do the simple things right]" claimed Souter, and management had stopped spinning plates. The shares which peaked at £2.85 in 1998 reached 10p in late 2002, or half their IPO price ten years earlier. When the final dividend was cut in July 2002, management were sacked and Souter returned from semi-retirement.

Souter began cutting away the weak businesses, a process Charlie Munger, vice Chairman of Berkshire Hathaway refers to as the "cancer surgery approach". This often works because there is normally a jewel at the heart of most companies that has often been used to fund new ventures or is taken for granted by impatient management. As the jewel becomes diluted by less successful projects aggregate performance declines and valuations atrophy or even fall. The star in this regard and in which Mr. Munger invested, is Coca-Cola, which in the mid 1980s had become a poorly defined conglomerate including a shrimp farm, winery, film studio and shudder to think, even owned its own bottling plants! As the poorer businesses were cut away, to reveal the jewel that is the syrup manufacturing and marketing operation, the shares of Coca-Cola rose over ten fold in the succeeding decade.

At Stagecoach the fix is relatively simple: cease investment in poor US operations, sell the worst businesses for asset value, repay the debt and in doing so return the business to its jewel, the UK bus operation. When Marathon met Souter in early December he referred to the UK operations as being under the shadow of more recent acquisitions (a “Cinderella Business”) but that “they [management and employees of UK Bus] were the only people happy to see me back”: Souter is looking forward to spinning plates again. The firm has the relative luxury of a modern bus fleet and so the firm’s high levels of free cash flow can be used to repay debt. The banks have been supportive, even to the extent of allowing the company to repurchase its public debt (at sizeable discounts to face value) even though the public debt is due after the bank’s own debt facilities expire. All creditors are unsecured, and there remains debt capacity at some subsidiaries such as in Hong Kong and New Zealand. In our opinion the business is worth approximately 60p per share, a valuation contingent upon modest levels of debt repayment and no growth in the UK operations. This compares with Nomad’s purchase price of 14p (in late November), and the current market price of 33p (early January). Souter’s sacred dividend (with his sister he continues to own around 25% of the equity) is being maintained and implies a gross yield of over 12% at Nomad’s purchase price. Having analysed many complicated and highly indebted businesses especially in the US recently, Stagecoach’s problems are relatively simple, and we have made the firm our largest investment to date.

At Costco Wholesale there is no need to fix the business which is performing well already. Costco is one half of the wholesale club warehouse duopoly (with Sam's Club) and had annual revenues of U$35bn in 2001. The retail concept is as follows: customers pay an annual membership fee (standard U$45) which provides entry to the stores for a year, and in exchange Costco operates an every-day-low-pricing strategy (EDLP) by marking up 14% on branded goods and 15% on private label with the result that prices are very, very low. This is a very simple and honest consumer proposition in the sense that the membership fee buys the customer's loyalty (and is almost all profit) and Costco in exchange sells goods whilst just covering operating costs. In addition by sticking to a standard mark up savings achieved through purchasing or scale are returned to the customer in the form of lower prices, which in turn encourages growth and extends scale advantages. This is retail’s version of perpetual motion and has been widely employed by Wal-Mart among others. To understand how important EDLP is to Jim Sinegal, the firm’s founder, consider the following story which was recounted to us by a company director. Costco bought 2m designer jeans from an exporter and shipped them into international waters and re-imported the jeans for an all in price of U$22 or so per pair. This was U$10 less than the firm had sold the jeans for in the past (offering the potential for a 50% mark up) and half the cost of most other retailers. One buyer recommended taking a higher gross margin than was usual (i.e. more than the usual 14% mark up) as no one would know. Apparently Sinegal insisted on the standard mark up, arguing that if "I let you do it this time, you will do it again". The contract with the customer (very low prices) must not be broken.

Many retailers do not operate in such a way, and instead employ high-low price strategies, that is to say they take prices up and down in an attempt to influence store traffic. The consumer goods companies then add to the confusion through running their own promotional campaigns. Although many of us are used to this behaviour, consider for a moment how confusing a proposition to the consumer it is. For example

is a bottle of shampoo worth U$2 if it is periodically available through a couponing campaign for U$1? The high-low strategy may even backfire: do consumers feel taken advantage of when paying U$5 for tissues that were available last week for U$4? They should. At Costco the consumer knows the price is 14 or 15% above wholesale, period.

Costco management describe the strategy as “easy to understand and hard to operate" perhaps because the temptation is to mark up the goods and break the contract with the customer. Costco is profitable enough to self fund growth of around 14% per annum and not to have to resort to leases for expansion (The Gap's mistake). This means that growth will be more measured (none of the 30% per annum purges that populate the retail industry) and should be more sustainable. As to the potential for growth the firm has 21 stores in Washington State which houses just 2% of the US population. This density coast to coast implies room for around 1,000 US stores (currently 284) and 200 stores in the UK (currently 14) although planning regulations may not allow for this. Even then Home Depot, the largest DIY store in the US currently has 1,500 stores. At 10% growth per annum, this implies the firm has another 13 years of growth ahead. The share price has declined from a year 2000 high of U$55 to U$30 (Nomad’s purchase price) as margins declined slightly (they are measured in basis points at this firm) with the cost of several new distribution centers which will support the next few year’s growth. For example in the UK the firm has warehousing and logistics capacity for 40 locations but only has 14 stores. At U$30 the firm is valued as a cash cow, with higher levels of profitability (as capacity utilisation increases) and modest levels of growth justifying a valuation over U$50 per share. Costco is as perfect a growth stock as we have analysed and is available in the stock market at a close to half price.

A few pieces of housekeeping and a final word on the need for patience. We are aware that several investors are new to the fund and so it may be worth reiterating some ground rules so that we all know where we stand. You can expect from us an annual and interim letter (this is our second annual letter), and Global Investment Reviews eight times a year in which we discuss our investment thoughts. In our opinion these documents, once digested, provide the information needed to form a judgement about what and how we are doing. From Nomad’s administrator (Daiwa Securities Trust and Banking, +353 1603 9921 for your inquires) you can expect a monthly statement of your account and annual and interim financial statements. Nomad’s orientation is genuinely long term, and more regular reports, daily, weekly, monthly or otherwise, are likely to be of little value to you, and may even be counterproductive for us.

One of Nomad’s key competitive advantages will be the aggregate patience of its investors. We are genuinely investing for the long term (few are!), in undervalued firms run by management teams who may be making decisions the fruits of which may not be apparent for several years to come. In the near term our results are as likely to be bad as good, but we are confident that in the long run they will prove satisfactory. If Nomad is to have a competitive advantage over our peers this will come from the capital allocation skills of your manager and the patience of our investors. In the latter we have started well, with no investor turnover since we began and almost no enquires into performance despite the general decline in market prices. This is very unusual and a huge credit to our investors, and implies a similar long

term outlook. Only by looking further out than the short term crowd can we expect to beat them. It is for this reason we named Nomad an Investment Partnership and not a fund. The relationship we seek is quite different.

As always we thank you for your confidence and value your support.

Yours sincerely

Nicholas Sleep.

Nomad Investment Partnership.

Interim Report
For the period ended June 30th, 2002.

The Nomad Investment Partnership's gross results for the second quarter and first half of 2002 as well as since inception are shown below, together with comparable results for a leading global stockmarket index:

To June 30th 2002	Nomad Investment Partnership	MSCI World Index US$
3 months	-4.67%	-8.99%
6 months	+3.99%	-8.60%
Since inception (10/09/01)	+14.54%	-5.22%

In the context of the time frame of the Partnership, I'm afraid the above results are not that meaningful as they are, after all, just nine months in the making. They are perhaps a reasonable start, certainly compared to the alternatives presented by the main indices. Even so it is absolute returns that we are after, and on this score our results are fair.

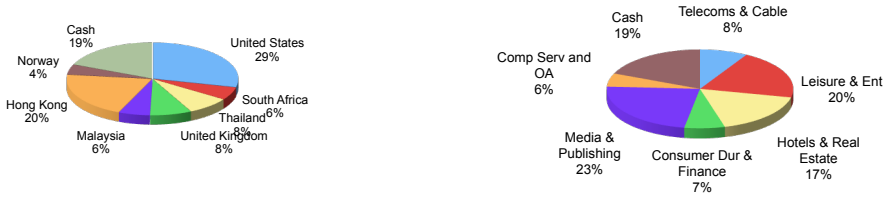
Some insight into our performance can be gleaned from the early Buffett Partnership letters to investors which we were fortunate enough to be sent recently. In the 1960 letter Buffett writes:

"I have pointed out that any superior record which we might accomplish should not be expected to be evidenced by a relatively constant advantage in performance compared to the Average. Rather it is likely that if such an advantage is achieved, it will be through better-than-average performance in stable or declining markets and average, or perhaps even poorer-than-average performance in rising markets."

We had not explicitly thought of investment outcomes in this way, although it is axiomatic that results for value investors during booms will be poorer than average and results after booms, better than average. Marathon's long term track record demonstrates the same pattern, and Nomad's performance since inception is also in line with this phenomena. You should therefore be expecting us to do relatively well as the bubble collapses.

Some investors have asked for statistics to help describe the characteristics of the fund. We have included here what may be useful: The Partnership has been invested in twenty-one companies in seven countries. Bloomberg classify these businesses into eighteen different industries although their classification is perhaps rather narrow. In our opinion, the Partnership has a notable concentration in relatively few sectors: media and publishing; leisure, entertainment and casinos; and hotels and real estate. Smaller investments have been made in telecoms and cable; consumer durables and finance; and computer services and office automation. The distribution of investments by geography and industry is illustrated pictorially below.

Chart 1: Distribution of investments by geography and industry



Source: Marathon Asset Management

The fund has a profit on eighteen of its twenty-one investments compared to average purchase price. For those shares that have fallen we have bought more. This reminds us of "A Little Wonderful Advice" Fred Schwed gives in his book "Where are the customers yachts?" (recommended reading for those with a healthy disdain for Wall Street and its practices as well as an interest in post-boom psychology).

"When there is a stock-market boom, and everyone is scrambling for common stocks, take all your common stocks and sell them. Take the proceeds and buy conservative bonds. No doubt the stocks you sold will go higher. Pay no attention to this – just wait for the depression which will come sooner or later. When this depression – or panic – becomes a national catastrophe, sell out the bonds (perhaps at a loss) and buy back the stocks. No doubt the stocks will go lower still. Again pay no attention. Wait for the next boom. Continue to repeat this operation as long as you live, and you'll have the pleasure of dying rich".

The operative phrase here is “pay no attention”. This is not easily done. Many investors are professionally required to “pay attention” to the latest trend for fear of missing out (pay attention and be invested!). The dysfunctionality of the short term investor was neatly described to us recently by a fellow long term value investor. Imagine, he said, that you knew with 100% certainty of outcome, that on January 1st next year a company would come by some good fortune, perhaps a government contract or license award, which would result in the price of the share quickly rising tenfold. You and I would buy the shares today and wait. However, to the short term investor the utility of this piece of information would be nought until after this year is ended. This is because he feels he is required to perform this quarter, next and by year end through fear that sub-par performance might cost him his job. A share which may be flat for the balance of the year is therefore of no use to him. This tale illustrates the dominant dynamic in the markets today: investment time frames are very compressed, and few investors it seems bother to assess the real value of a business but instead respond to the latest data point to determine share price direction. This is momentum investing and is the mechanism by which expensive shares become very expensive, just as cheap shares may become very cheap. In the above example both sets of investors may even have privately agreed that the share in question was an outstanding investment, but only one would have bought. You can bank on us being the buyer.

This is not a wholly theoretical discussion. Only this week Estée Lauder, a company which we much admire and would consider owning if only someone would sell it to us at a reasonable price, announced that earnings would decline as the firm had decided to invest in brand building instead. Such investment could be expected to raise long term revenue growth and pricing power but even so the share price declined 15% on the news. The reason was that short term investors responded to the warning about next quarter’s profits and missed the long term outlook. As Fred Schwed would say “pay no attention to this”. In effect the company had been punished by the markets for being sensible. It is this behaviour that gets us excited and sets up investment opportunities.

A few final statistics on the fund’s characteristics. Approximately 37% of the fund is invested in quality, difficult to copy, franchise operations such as newspapers, a TV station, motor racetracks, consumer brand names and casinos; 27% is invested in what could be described as discounted asset based businesses such as property, hotels, or conglomerates where fixed assets or cash makes up a large portion of appraised value, and finally 17% is invested in deep value workouts such as Xerox (see below) where prices are depressed by temporary factors such as short term profits, debt or the legacy of previous management. It is the first category that contains our current winners and the latter that contains our losers. In time both will contain winners. In aggregate we estimate our investments are currently priced by the market at 51% of their real worth, that is to say in our opinion we have bought dollar bills for 51 cents.

In our last letter we described our investment in International Speedway (the Nascar racetrack operator) and Matichon (Thailand’s second largest newspaper business), and in recent Global Investment Reviews we have discussed investments in Saks and Primedia. That’s 20% of the portfolio covered. In this edition I thought we might discuss an investment you are likely to have read about in the press, Xerox

Corporation, and an error in analysis, Monsanto Company, which we sold. That way you will be under no illusion about the fallibility of your manager.

Xerox will be familiar to many as the manufacturer of presses, copiers and printers. The firm has annual revenues of U$17bn and a niche in high end (U$100,000+) printers where the firm has around 70% market share. It is a reasonably profitable but modest growth operation. The firm enjoyed several good years in the early and mid 1990s following the introduction of a new generation of machines but by the late 1990s growth had declined markedly. Perhaps aware that Wall Street rewarded earnings growth above all other metrics, management asserted that earnings per share would rise by 15% per annum and the shares began to rise to discount the near certainty they would. However 15% growth in earnings is tricky to achieve for any length of time especially from a 5% revenue growth business and management began, and indeed was egged on by Wall Street, to find growth from an alternative source.

In a cartoon carried in the Wall Street Journal two accountants sit opposite each other in a prison cell. You know, one says to the other, in accounting it is best to think inside the box! Xerox management would have done well to read this cartoon in 1996 or 1997 as it was about that time that management began to push too hard to grow earnings. One of the ways this was achieved was through booking profits from long term lease contracts upfront. It is quite possible, indeed likely, that one could have a happy and successful life without knowing about lease and sale accounting, so if the topic bores you, skip the next paragraph.

For everyone else, welcome to the Statement of Financial Accounting Standards No. 13 "Accounting for Leases". We will try to be brief. There are two types of leases, operating and sale-type. Under an operating lease a lessee rents an item for a short period and the total rent payments are usually a fraction of the value of the rented item. Car rental contracts are usually of this type. The difference between an operating lease and a sale-type lease is a matter of scale. A sale-type lease is usually for a much longer period and in effect transfers a much larger portion of the economic value of the asset to the lessee, a contract for the use of an airplane for the rest of its economic life would be a sale-type lease. The former is rental contract, the latter more of a sale. Now for the accounting. The accountants differentiate between the two using SFAS 13 which states that that contracts which transfer 75% or more of the economic life of the leased asset, or where minimum lease payments are 90% or greater than the fair value of the asset, be treated as a sale-type lease, with lesser values treated as an operating lease. The crucial difference is how they are recorded in the accounts. Sale-type leases require the leased asset to be booked as if sold outright, in effect bringing forward revenues and profits. In contrast, payments under an operating lease are booked incrementally over the lease term. It is important to note that whether a transaction is deemed an operating lease or a sale-type lease, cash flow is unaffected. The customer still pays the rental as required, it is only the accounting that implies something else has happened.

When Xerox leases an expensive printer it is often in the form of a five year contract which bundles equipment, a service contract and financing. However, in a bundled contract there is some discretion as to how much is attributable to the value of the equipment and how much should be deferred to later years in recognition of financing, maintenance and service. One can therefore understand how management,

plump with stock options and growth in earnings per share related bonuses, were strongly incented to recognise earnings up front and SFAS 13 allowed them to do this. The value of the equipment was incorrectly raised relative to service, financing and maintenance which allowed the firm to treat the transaction as a sale-type lease and required that the inflated equipment value be booked as if sold. A double whammy of inflated revenues and profits recognised early. This does not appear to be illegal, although it is hardly conservative. It may even have mattered less if Xerox had not relied upon the commercial paper market to fund its receivables business. When the company announced that earnings would be below Wall Street expectations, the SEC announced an investigation into the firm's accounting and the auditors were replaced, the result was that the credit markets all but closed to the firm, and the shares declined to 7% of their peak price.

It is important to put this in perspective. In the five years to 2001, cumulative revenues at Xerox approached U$90bn, of which U$6.4bn was incorrectly booked. Cash flow and free cash flow, the basis of our valuation of the firm, is completely unaffected. Customers continued to pay their bills monthly as arranged. Operating blunders associated with product extensions, again designed to raise the growth rate, have been reversed and investment in research and development maintained at around U$1bn per annum regardless of the turmoil all around. Earlier this year the firm completed negotiations with its banks to repay the debts over the next few years in easily digested increments that should be funded from internally generated cash flow and U$1.8bn of cash on hand. The operating turnaround is now well under way, and a new product cycle, in some lines the first new products for ten years, will see products launched at twice the rate of the late 1990s. Even after new auditors have been appointed the debate about the accounting continues. It is with some irony that the replaced accountants protest that Xerox's profit is now understated. Xerox might be alone in corporate America in this regard. And, as if to prove that truth is stranger than fiction, the new accounting methodology will result in higher revenues and profits over the next few years than under the previous discredited policy. This matters not a jot to us, note again: cash flow is unchanged.

So what is the business worth? The firm has around U$1bn in free cash flow per annum after interest, taxes and maintenance levels of investment spending (capex, marketing and R&D) which should permit the net debt of around U$2bn (U$17bn of total debts are offset against U$15bn of trade and long term receivables and cash) to be repaid over the next few years. Indeed, if the apple cart is to be upset, it is likely to come from a dilutive share issuance, something we are lobbying management to resist, hopefully more effectively than the bankers who are egging them on. The current market valuation of U$4.5bn is just four and a half years free cash flow or four and a half years research and development spending. We estimate the capitalised value of the R&D asset may be around U$7bn or approximately 50% more than the current market capitalisation. As a cash cow the firm may be worth around U$14 per share in our opinion, although the increase in new product launches from two per annum to four per annum during the next three years may result in modest growth as well. Presently the firm is valued at U$6 per share, less than half our appraisal of its real worth. Trading volume of Xerox stock implies investors own the shares for under four months on average, a time horizon which implies few investors are focused on the long term value of the business but rather are betting on the next quarter's outcome. Rich pickings, we suspect, for the patient.

Now for our analytical error. Monsanto manufactures and markets genetically modified seeds and fertilizers and is a business with good economics, good growth potential, good management and a low share price. It is right up Nomad's street. However, it is also a business with a past. In the mid 1990s Monsanto consisted of the seed business, a commodity chemical business (Solutia) and the G.D. Searle drug operations. In 1997 Solutia was spun off to shareholders in Monsanto and early in 2000 Pharmacia Corp bought the remaining Monsanto operations, before spinning out the seed business in order to retain the Searle drug business. The wrinkle however comes in the form of potential environmental clean up costs and punitive damages relating to Solutia's PCB plant in Alabama. Solutia's own balance sheet is encumbered with healthcare liabilities and debt and any award which cannot be met by Solutia passes on to the parent company, in this case Pharmacia. However, and here is the catch, Monsanto has indemnified Pharmacia for any environmental or punitive damages incurred as a result of Solutia's operations. We do not know if any, or indeed the size of any damages that may be awarded, and legal council cannot ascertain where an award would rank in the list of creditors in the event of Solutia's bankruptcy. This means we do not know how much, if any, of the liabilities would revert to Monsanto. What we are aware of is that value for us, the Monsanto shareholder, may be decided by a judge in an Alabama court, and on that basis we are nervous. In our original analysis we missed the indemnification and it was only on reading recent company filings with the SEC that the indemnification buried in the notes to the accounts came to our attention. The effect is that we are no longer confident of valuing Monsanto with any certainty and the prudent thing to do was to sell our shares for approximately the price we had paid. We have indeed been fortunate as the shares have since declined to half our sale price.

So where have we got to? The fund is 81% invested, and investment performance is reasonable in absolute terms and considerably better than the market averages. In the West investors are very short term oriented, skittish and share prices are volatile. It seems quite likely to us that over the next few years businesses will be very mis-priced in the market, and already there are pockets of real value emerging in the most despised industries. In Asia the profits cycle is only just beginning, if anything the bias is to understate profits for tax reasons and valuations remain modest.

A final word on the need for patience. We are aware that several investors are new to the fund since the beginning of the year and so it may be worth reiterating some ground rules so that we all know where we stand. One of Nomad's key advantages will be the aggregate patience of its investor base. We are genuinely investing for the long term (few are!), in modestly valued firms run by management teams who may be making decisions the fruits of which may not be apparent for several years to come. Mr. Buffett's comments not withstanding, in the near term our results are likely to be as bad as they may be good, but we are confident that in the long run they will prove satisfactory. If Nomad is to have a competitive advantage over our peers this will come from the capital allocation skills of your manager (if any) and the patience of our investor base. Only by looking further out than the short term crowd can we expect to beat them. It is for this reason we named Nomad an Investment Partnership and not a fund. The relationship we seek is quite different.

As always we thank you for your confidence, value your support and welcome your questions.

Yours sincerely

Nicholas Sleep.

18th January 2002

To the Partners of the Nomad Investment Partnership.

The Nomad Investment Partnership was launched in early September 2001, and began investing on September 10th. In the brief period since inception the fund has risen 10.1%, which compares with a gain of 3.9% for the MSCI World Index. Unaudited gross NAV per share at the end of December was U$1101.42. Nomad is an absolute return fund and reference here to an index is simply to place our performance, short term as it is, in context. We expect to beat the index handsomely over time, but only as a by product of our absolute return orientation. We also expect the absolute return of the main indices to be modest over the next decade and so the index is not likely to be much of a return hurdle.

You can expect from us an annual and interim letter (this is our inaugural annual letter), and Global Investment Reviews eight times a year in which we discuss our investment thoughts. From Nomad's administrator (Daiwa Securities Trust and Banking, contact Dane Schmidt +353 1603 9921 with your inquires) you can expect a monthly statement of your account and annual and interim financial statements starting in June 2002. We are considering hosting an open day once a year (any feedback on whether this would be a good idea would be appreciated) and we are always available for your inquiries by phone or letter. Nomad's orientation is genuinely long term, and more regular reports, daily, weekly, monthly or otherwise, are likely to be of little value to you, and may even be counterproductive for us.

As it turns out our launch date was rather fortuitous. The price of businesses fell almost immediately and despite regular additional contributions by new investors we were able to invest a sizeable portion of the fund much faster than we would have anticipated and at prices which we feel will produce very satisfactory returns. We have made 18 investments to date which Bloomberg classify in 16 different sectors which are detailed overleaf. The Bloomberg sectoral categories are rather narrow and there is in fact a notable concentration in media (TV, newspapers and publishing) at around 21% of the portfolio and hotels, resorts and casinos which make up 12% of the fund. The next largest grouping is telecom services (mobile and cable) which make up 10% of the fund. The geographical distribution is as follows: south east Asia 32.8%; North America 23.6%; Europe 12.7% and other emerging markets 2.9%.

When we evaluate potential investments we are looking for businesses trading at around half of their real business value, companies run by owner oriented management and employing capital allocation strategies consistent with long term shareholder wealth creation. Finding all three is rare, and that is why we think Nomad has a material advantage in being a global fund. We can look far and wide for candidates and simply are not required to invest in anything that does not fit. Chris Browne of Tweedy Browne has likened the research process to detective work or perhaps investigative journalism, and we could not agree more.

One feature of our investment letters will be to highlight one or two of our investments or discuss investment issues at large. For those of a particularly inquisitive or analytic nature we may in the future enclose some meeting notes as well. This time we have selected two current holdings which we hope will be typical of Nomad's stock picks. The first is International Speedway in the US, and second is Matichon in Thailand.

International Speedway (approx 3.7% of the portfolio at year end) owns and operates 12 motor racing circuits in the US including Daytona, Watkin's Glen and Talladega, and plays host to 20 of the 39 Nascar races. The National Association for Stock Car Auto Racing (Nascar) was founded in 1948 by Bill France who had organised motor races at Daytona Beach in the period before the war. During the war the beach circuit fell into disrepair and so on his return France set about renting local circuits to host races, but he felt that the sport really required a sanctioning body to set common standards for competitors and track safety (a relative rarity at the time) to lift its image from its moonshine legacy. After the American Automobile Association refused to endorse his idea France established Nascar himself, and was announced its first president in 1948. From the beginning France intended Nascar to be exciting and publically accessible, as well as sponsor friendly, and the formula evolved toward big fields of very fast cars (200mph+) on banked circuits surrounded by large atmospheric stadia.

Until quite recently motor racing has been a very fragmented sport: sanctioning bodies have tended to splinter into rival factions which form their own leagues, and the race tracks have developed on an ad hoc basis (some were originally perimeter roads to local airstrips) and remained under family ownership. Formula One with its dominant sanctioning body and almost totalitarian leadership under Bernie Ecclestone is both the exception, and due to its huge commercial success, the benchmark. International Speedway has grown through building and buying circuits throughout the south east and more recently elsewhere in the US. But the real prize from consolidation is that the firm has substantially improved its bargaining position with the broadcasting companies. Instead of their being more tracks and sanctioning bodies than media buyers, the tables have now been reversed. The attraction to advertisers is that Nascar runs races most weekends (good for filling programming schedules), is US only (unlike Formula One) and attracts middle America in droves. When the industry recently negotiated an exclusive seven year media rights contract the rate doubled in year one, and for the period to 2007 are contracted to rise by a further 17% per annum. Whilst this is promising in itself such events are quickly discounted by the markets, and the shares rose to a peak at U$70 two years ago.

Our interest is in how the windfall is being distributed: the France family (which owns Nascar) will take 10%, note this sum compares with much closer to 100% for Mr. Ecclestone's take of Formula One revenues, 65% is divided between the tracks (of which ISCA earns the lion's share), and 25% goes in prize money to the drivers and teams. This final point may be important because as prize money increases it may establish a virtuous cycle of new entrants attracted by the increased "pot", which in turn may raise viewing audiences and media attention. It is encouraging that the Chrysler racing team have recently announced their return to Nascar after a multiyear absence. In other words the firm may be deferring part of the windfall to fund future growth, which will be incremental to the escalating media income.

The price of ISCA shares at the time of Nomad's investment (around half their peak level) was a small premium to replacement cost of the circuits and a valuation which discounted only low single digit growth in profits. Cash flow growth will likely be cyclically subdued in the near term and investors with a short term time horizon, which appears to us to be the majority of professional investors, will have little to excite them. This is fine by us, because the outlook for the next five to ten years is very positive. Finally, how do CBS and Fox feel about their new Nascar contracts? They claim they are very encouraged, they now have to negotiate with one party to fill 40 weekend programming schedules and viewing audiences have exceeded their budgeted projections. Fox has recently bought a dedicated motorsport cable channel to host their Nascar coverage. Roll on contract negotiation in 2006! In discounting growth of just 3% to 4% the market valued the business as if it was just an average firm, when in our opinion International Speedway is a rock solid franchise with improving economics and could be a multiyear winner for investors that are patient enough to wait.

Matichon (3.2% of fund at year end) is Thailand's second Thai language newspaper and is a company we have known for many years and in which Marathon is also the third largest shareholder. We do not read Thai and take it on trust from Thai friends that the editorial content is pro-reform and it is certainly tabloid in style which sets it aside from Thailand's largest newspaper (Thai Rat) which is more "old Thailand". Matichon is probably not the Washington Post, but it's healthily questioning nonetheless. The paper appeals to the new generation of Thais that have grown up with a much higher living standards and more western values than their parents and it is interesting that circulation has grown at an accelerated rate since the Asian crisis. The firm is family run and has avoided the pitfalls of straying into new media or gambling on new titles. Instead the firm has focused on raising longer term readership and margins. In an effort to promote circulation the cover price has been kept low but this has the effect that the majority of revenues comes from advertising which is far more cyclical and means that revenues declined by a third peak to trough. The cost cutting effort however has been amazing, with the effect that cash flow in 2000 is 40% higher than 1996, on sales one third less! 2000 is the first year of a cyclical recovery in advertising, and rates are now 20% above their trough but around 50% below the previous cyclical peak. In other words there may be a long way to go.

So, what is Matichon worth? The shares peaked at Tb300 (U$12) in 1994 and have now declined to Tb50 (U$1, adjusting for the decline in the currency). The share price decline is all the more amazing as the firm is without debt. Our company is presently valued at 0.75x revenues or four times our estimate of normalised free cash flow. This

is approx one third of our estimate of its worth, and may be as low as one quarter of the valuation of its western peers. The family owns 25% of the shares and has taken the gains from cost cutting to raise the dividend three fold since the trough, and so investors now have a 9% dividend yield whilst they wait for the cycle to improve. And improve slowly it is, rates are expected to rise gently this year and next, so patience is likely to be rewarded here too.

So, nearly four months since inception where are we now? Our investments are presently priced in the markets at considerable discounts to our assessment of their real worth, performance is satisfactory and we remain with substantial cash holdings of approximately 28% of the fund at year end, although you can expect this to decline markedly. Whilst we are conscious that holding cash does not meet our long term investment goals (to say little of earning our incentive fees) we are in no hurry to invest the money in companies that do not meet our criteria. The markets are very volatile, and we expect to operate with some cash or bond holdings as a matter of course. We also have many ideas that we are working through. You can also be assured that Marathon insiders are the largest group of investors in Nomad.

As always, we value your support and welcome your comments.

Yours sincerely

Nicholas Sleep

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