

**Nomad Investment Partnership.**  
**Interim Report**  
**For the period ended June 30<sup>th</sup>, 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 stock market index:

To June 30 <sup>th</sup> 2002	<u>Nomad</u> <u>Investment</u>	<u>MSCI World</u> <u>Index US\$</u>
3 months	-4.67%	-8.99%
6 months	+3.99	-8.60
Since inception (10/09/01)	+14.54	-5.22

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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.

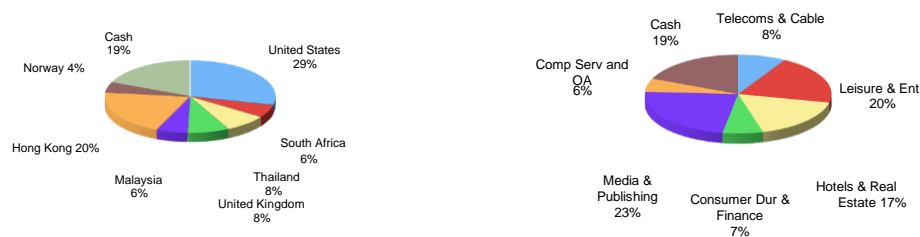
Some insight into our performance can be gleaned from the early Buffett Partnership letters to investors which we were fortunate enough to be sent recently. In the 1960 letter Buffett writes:

*"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 phenomenon. 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 1<sup>st</sup> 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 counsel 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 notwithstanding, 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