

## Nomad Investment Partnership.

### Annual Letter.

For the period ended December 31<sup>st</sup>, 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 pretense 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 31 <sup>st</sup> , 2003	<u>Nomad Investment Partnership</u>	<u>MSCI World Index (net) US\$</u>
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 31 <sup>st</sup> , 2003:	<u>Nomad Investment Partnership</u>	<u>MSCI World Index (net) US\$</u>
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

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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 Consec six times over and yet it was Consec 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 US\$1 of value into US\$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 US\$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<sup>3</sup>. 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 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 muddled 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 guesstimated 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 publicly 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