

## Nomad Investment Partnership.

### Interim Report For the period ended June 30<sup>th</sup>, 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 30 <sup>th</sup> , 2003:     | <u>Nomad Investment<br/>Partnership</u> | <u>MSCI World<br/>Index (net) US\$</u> |
|--------------------------------------|---|--|
| From: December 31 <sup>st</sup> 2002 | +26.0%                                  | +11.1%                                 |
| December 31 <sup>st</sup> 2001       | +27.7                                   | -11.0                                  |
| Since inception (10/09/01)           | +40.6                                   | -7.8                                   |
| Annualised since inception           | +20.4                                   | -4.3                                   |

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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  $((1+0.406)/(1-0.078))-1 \times 100$ )! 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, when we will be right”* (the sequence of annual outcomes), *“but the accuracy of our analysis of the company will largely determine whether 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 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.