

## Nomad Investment Partnership

### Annual Letter For the period ended December 31st, 2005

To Dec. 31st, 2005	<u>Nomad Investment Partnership</u>	<u>MSCI World Index (net) US\$</u>
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. 10 <sup>th</sup> 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:	<u>Nomad Investment Partnership</u>	<u>MSCI World Index (net) US\$</u>
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. 10 <sup>th</sup> 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 piddly 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 divided 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.

#### More on the principal/agent conflict

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.

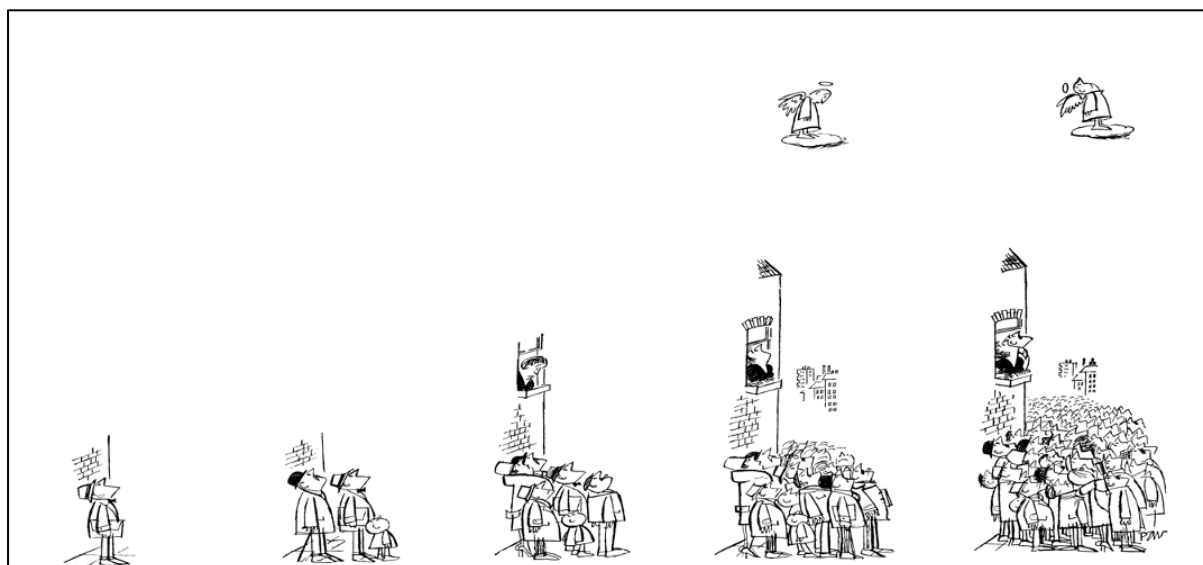
And securing the destination is much harder to do if you are trying to beat the index in annual increments at the same time. Nassim Nicholas Taleb (author of “Fooled by Randomness”) published an interesting paper (free, on the internet) which also linked the sequence in which returns occurred to how 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 mis-judgement, 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.



Reproduced under licence and with the kind permission of the Punch Cartoon Library.

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 mis-judgement 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 the main difference between and himself the average investor is, 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 then 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 eke 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 number 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 (US\$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 US\$1 into US\$16 over 20 years, which would be stunning, then sitting at just below US\$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 (Thornton's 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.

Speech given to the board of The Investment Fund for Foundations at the invitation of Mike Costa and David Salem, September 26<sup>th</sup> 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 into 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 gatecrasher, 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. Let’s 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 it’s 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 cover 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 Mis-judgement" 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, deprivation 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 mis-judgements 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 mis-judgement 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 black. 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 can't 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 it's in the headlines it's 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 mis-judgement 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, it's 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 world. That's how behaviour finance should be used. But it probably won't...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 “Let's 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 -old! ' 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-weighting 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 eke out some value added in the mind of their clients and it creates these counterproductive 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-weighting 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 let's go through some of these psychological mis-judgements 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 weekday, 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 nowhere 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 it's 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.

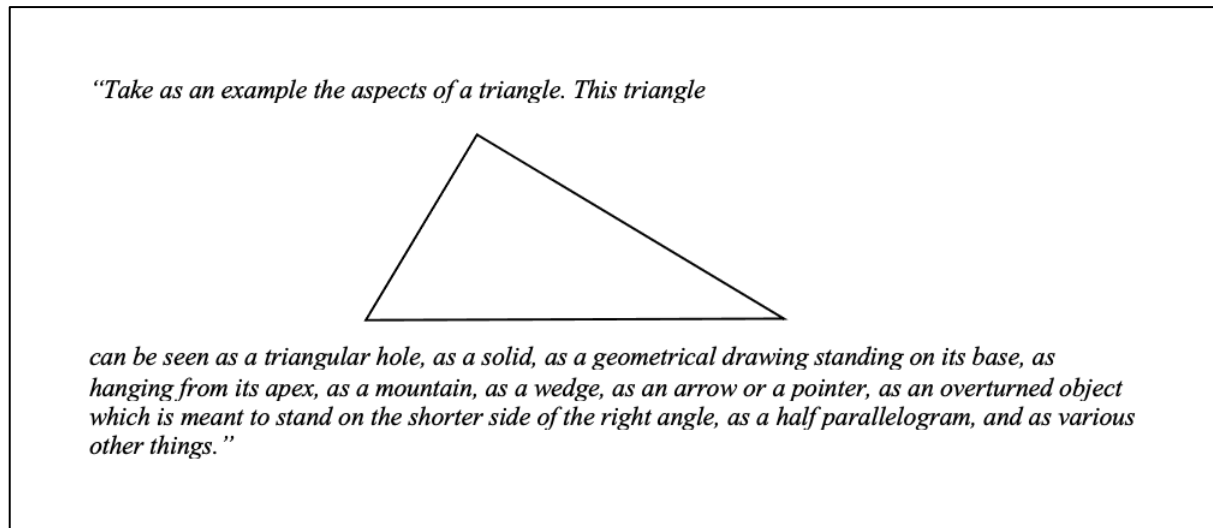
I’ll let Mauboussin have the last word...

*“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...

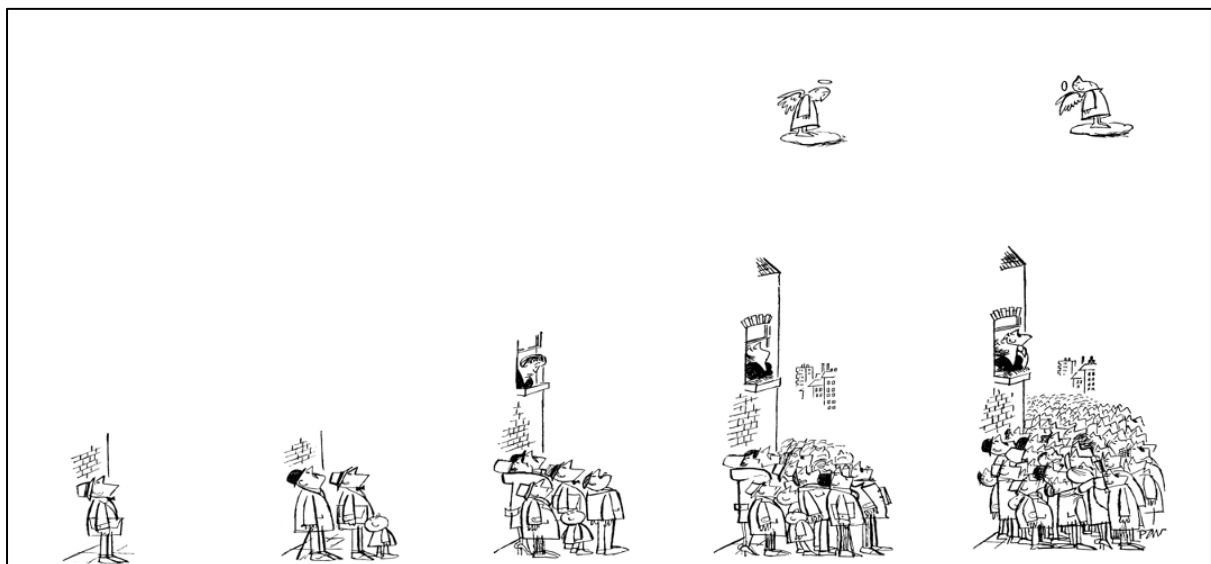
Slide 1: Speech Title “So how does Zeckhauser play bridge?”

Slide 2:



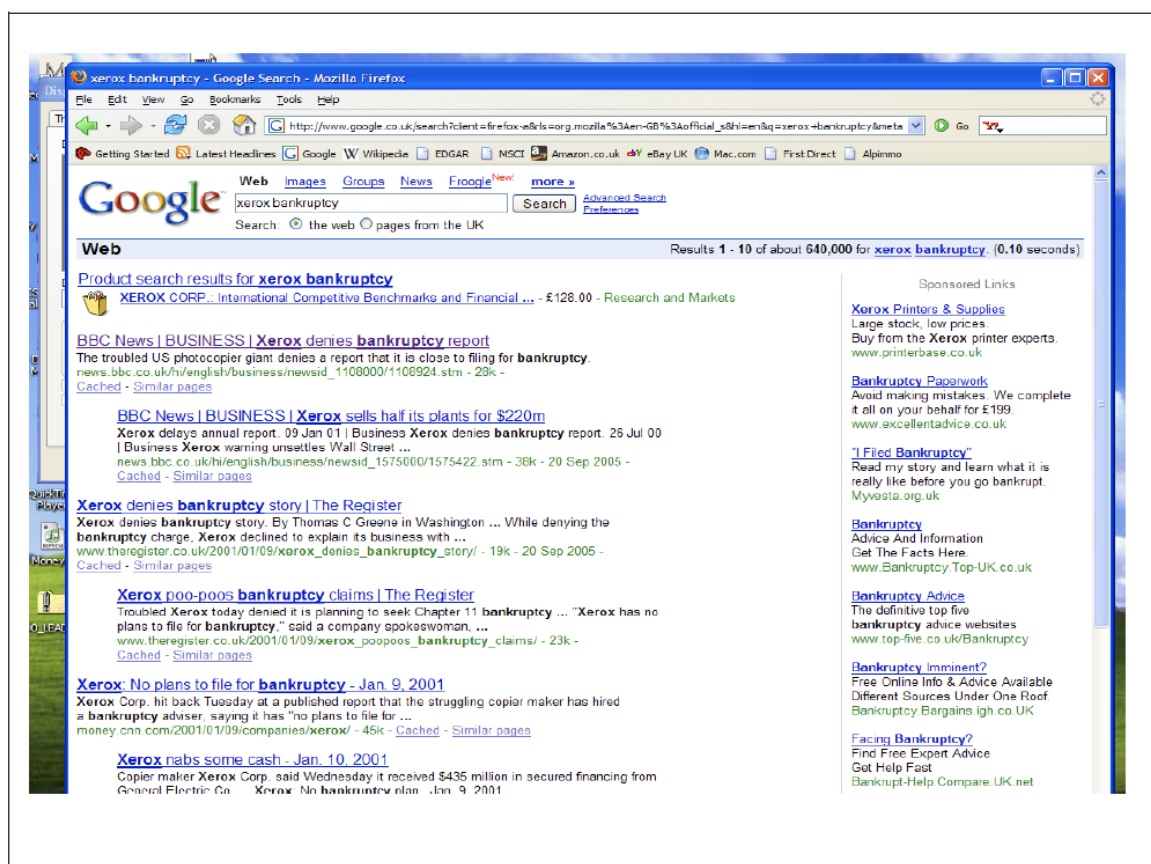
Source: Ludwig Wittgenstein, *Philosophical Investigations*

Slide 3: The Punch Cartoon



Reproduced under licence and with the kind permission of the Punch Cartoon Library.

## 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 and 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.