

Nomad Investment Partnership
Annual Letter
For the period ended December 31st, 2004

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

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

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

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

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

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

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

Growth and Value

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

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

Source: Berkshire Hathaway 1992 Annual Report

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

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

Why we think what we think

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

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

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

Why is no one doing a good job?

Among the best performing stocks of the 1990s were EMC, Dell, PMC Sierra and Microsoft. These were the cheapest stocks a decade ago, but no value investor owned them. But then again, none of the large growth investors (excluding insiders) owned the shares all the way through the decade either. Why is this? Why weren’t value investors, those who claim to be good at pricing a business, invested in Dell in 1990? Why is no one doing a really good job?

No, we weren’t invested in Dell either. Worse still, we weren’t looking. Although Dell was not expensive at the time, I am sure we would have concluded that its probability of failure over the next decade would have been high, or at least high enough to stop us owning the shares. A study by Michael Goldstein at Empirical Research, a research boutique, claims that

the probability of growth stock failure (company growth slowing) is as high as four in five over five years and nine out of ten over ten years. And in the case of Dell, we would have been wrong. We take no comfort from the fact that not seeing success is a perennial investment mistake: in the 1950s a large Baltimore based fund management company sold their clients' shares in IBM only for the shares to appreciate to the point that the value of the shares sold would become bigger than the whole fund management company itself. What we are trying to do today is avoid the Baltimore company's second mistake, which was to sell an equally big stake in Wal-Mart in the 1970s!

When investors describe themselves as growth or value it might be helpful to have two questions in mind. To the value investor ask, "what is it about your approach that would have stopped you owning K-Mart for much of the last twenty years?" (K-Mart was a "cheap" stock, as measured by say price to book value – but a dreadful investment, recent performance notwithstanding), and to the growth investor ask, "what is it about your approach that would have stopped you selling Wal-Mart?". So how does one avoid these mistakes? The answer lies in analyzing not the effects and outputs of a business, but, digging down to the underlying reality of the company, the engine of its success. That is, one must see an investment not as a static balance sheet but as an evolving, compounding machine.

Deconstructing the Business case for Costco Wholesale

We have written about Costco before (December 2002) but make no apologies for its inclusion again. The reason is that it is important to us that you understand not only what we do, but why we do what we do. This is not easily done, as I am sure I will now demonstrate. In our experience very few investors understand what their managers really do. We know this because fund managers are often sacked at the trough of their relative performance, and invariably just as performance is about to turn. Clients that sacked Marathon at the end of 1999 (you know who you are) have missed out on a 12% annual gain compared to the index since, a gain which far outstrips any deficit against the benchmark during previous years. So, education is important. It helps both parties make rational decisions. Costco is also an important investment for the Partnership at close to 10% of assets. I am also conscious that in the September issue of the Global Investment Review, your manager wrote an article explaining the risks of doing precisely what he is about to do. That is, by publicly committing to an investment it may become harder subsequently to change one's mind. A copy of the essay is contained in the appendix. However, on the basis that fore-warned is fore-armed, I shall continue. You will understand if we don't sell our shares just yet!

Costco Wholesale is a member-only wholesaler of consumer goods. Membership is available to the public at a price of U\$45 per annum. The act of purchasing membership has the effect of raising the company's share of mind with the customer in the same way that consumer goods companies hope to achieve with conventional advertising. At Costco, the consumer has chosen to commit to the retailer. In other words, people shop at Costco because it is Costco, not because Costco stocks Coke. And the reason they shop is that goods are priced at a fixed maximum 14% mark up over cost. The fixed mark-up is referred to in the industry as "every-day-low-pricing" or EDLP, in order to differentiate it from normal industry practice of changing prices in an attempt to influence traffic, or so-called high-low pricing. At Costco the consumer pays no more than 14% over what the company paid, period. In the December 2002 letter to shareholders, we wrote:

“To understand how important EDLP is to Jim Sinegal, the firm’s founder, consider the following story which was recounted to us by a company director. Costco bought 2m designer jeans from an exporter and shipped them into international waters and re-imported the jeans for an all-in price of U\$22 or so per pair. This was U\$10 less than the firm had sold the jeans for in the past (offering the potential for a 50% mark-up) and half the cost of most other retailers. One buyer recommended taking a higher gross margin than was usual (i.e., more than the usual 14% mark-up) as no one would know. Apparently Sinegal insisted on the standard mark up, arguing that if ‘I let you do it this time, you will do it again’.”

Most supermarkets mark-up goods in aggregate by twice as much (in margin terms) as Costco and even the mighty Wal-Mart marks up by half as much again as Costco. In order to make money at such low (gross) margins Costco must ensure that: (1) Operating costs are low, indeed very low. It is indicative of the paranoia with which the company is run that costs are measured in basis points (there are 100 basis points in one percentage point). This makes life difficult for Wal-Mart and the hypermarkets who cannot price at aggregate Costco levels and make money as their cost bases (approximately 15% and 25% of revenues respectively) are too high. (2) That the wholesale price is as competitive as can be. The key to negotiating terms is that the number of items in a store (stock keeping units) are fixed at 4,000, and the right to fill one of these spaces is auctioned, with the supplier that provides the best value proposition to the consumer winning space on the shop floor! Contrast this to normal industry practice whereby the supermarket assumes the role of landlord, auctions space to the highest bidder and pockets the rents (“slotting fees” in industry parlance). Many supermarkets make their money from buying from the supplier. Costco makes money from selling to the consumer. The firm publishes the criteria required to become a Costco supplier on its UK web site. After setting out the definitions of quality, pricing, packaging and gratuities (“expressly prohibited” for reasons we can all understand) there is the following statement about purchasing quotes:

“We expect all vendors to consistently and voluntarily quote the lowest possible acquisition price available on all items. A vendor who does not consistently and voluntarily quote its lowest prices to our buyers will be permanently discontinued as a purchasing source for Costco.”

Source: Costco.co.uk

Grief. One strike and you’re out!

(3) Revenues need to be very high. This last factor is partly a self-fulfilling prophecy – revenues will be high if the other factors, (1) and (2), are favorable. The issue is what the company then does with this revenue advantage. In the case of Costco scale efficiency gains are passed back to the consumer in order to drive further revenue growth. That way customers at one of the first Costco stores (outside Seattle) benefit from the firm’s expansion (into say Ohio) as they also gain from the decline in supplier prices. This keeps the old stores growing too. The point is that having shared the cost savings, the customer reciprocates, with the result that revenues per foot of retailing space at Costco exceed that at the next highest rival (Wal-Mart’s Sam’s Club) by about fifty percent.

The stores are mainly owned rather than leased. This makes sense in terms of controlling costs (no greedy landlords putting up rents) but also means that growth is measured and predictable, if slower than Wall Street might like. But this is fine with us if it means that the probability

of continued success is higher than under a going- for-broke expansion plan.

In the office we have a white board on which we have listed the (very few) investment models that work and that we can understand. Costco is the best example we can find of one of them: scale efficiencies shared. Most companies pursue scale efficiencies, but few share them. It's the sharing that makes the model so powerful. But in the center of the model is a paradox: the company grows through giving more back. We often ask companies what they would do with windfall profits, and most spend it on something or other, or return the cash to shareholders. Almost no one replies give it back to customers – how would that go down with Wall Street? That is why competing with Costco is so hard to do. The firm is not interested in today's static assessment of performance. It is managing the business as if to raise the probability of long-term success.

Deconstructing the Investment Case for Costco Wholesale

What is it about growth stocks that dooms them to failure? In other words, why is Michael Goldstein's growth stock failure rate, and our shunning of Dell, normally right? The answer is that success encourages competition, and capital flows into an industry to compete away the excess returns. Like all heuristics, this works most of the time, and we can all think of businesses that were super profitable for a while before the competition caught on. But what of those that don't fail? Michael Dell succeeded by keeping costs low and passing back his scale benefits to the buyer of his PCs. By the time the competition had matched him in pricing he had moved on. And on and on. (Perhaps someone could slip this letter into Carly Fiorina, Chairman and CEO of Hewlett Packard's suggestion box). Amazon.com may be following this path as well. So, the first point is that whilst Costco continues to recycle cost savings to the consumer, it is lowering the probability of failure.

So, what heuristics do investors incorrectly apply to Costco (why might the shares be mis-priced?). Heuristic One: "the company has low margins" (net profit margin is 1.7%, compared to Wal Mart at 3.6% and Target at 4.2%). True, but that's the point. The firm is deferring profits today in order to extend the life of the franchise. Of course, Wall Street would love profits today but that's just Wall Street's obsession with short term outcomes. Heuristic Two: "it's expensive at 24x earnings". Really? Net income is a small residual, as discussed above. The firm could earn Wal-Mart margins by taking pricing up a little, in which case the firm would be on 11x earnings, but would it be a better business as a result? We think not, if it allowed the competition to catch up. Heuristic Three: "Costco has a cost problem". Costs have risen as a percentage of revenues in the last few years due to the expense of a warehouse and distribution system associated with the next phase of the firm's growth and the cost of employee benefits and insurance, especially in California. This has people fooled who really should not be. At the annual general meeting for an investment company that we hugely admire, the investment firm's founder (and industry hero) was asked by a client why their holding in Costco was just 1% of the fund, especially when they have a reputation for portfolio concentration. The answer given was that of the firm's three constituencies (labour, customers and shareholders) the first two had been ascendant. This sounds nice and neat, but the phenomenon is cyclical: labour are "happy" according to Sinegal, Costco's founder and CEO, incremental stores will leverage fixed costs, and in the letter to shareholders Sinegal describes costs as "unacceptable". In short, they are on to it. Our investment hero was mistaken, by about US\$20 per share so far, or a gain of 65%.

Is it perfect?

No. But that suggests an interesting question: What characteristics could one bestow on a company that would make it the most valuable in the world? What would it look like? Such a firm would have a huge marketplace (offering size), high barriers to entry (offering longevity) and very low levels of capital employed (offering free cash flow). Costco has some of these attributes. The range of products is as wide as any retailer, and by-passing savings back it is building a formidable moat. It is also more asset light than its peers, but it is not the lightest of them all. For that one must turn to the Internet. In our opinion a business such as eBay could be the most valuable in the world. It has a huge marketplace, the biggest, an auction marketplace naturally aggregates to one player, offering high market share and high barriers to entry to the winner. Product pricing may be supported by the incumbent local newspapers and publishing businesses which have expensive machinery to replace and usually unionised labour and may provide a price umbrella for eBay. Better still eBay makes the customer pay for a high proportion of the assets used in the transaction such as PCs, modems, phone lines and so forth. But best of all, the incremental assets required to grow are so small. At Costco the firm will spend around U\$15m per incremental store which will serve a radius of perhaps thirty miles. U\$15m is a lot of servers for eBay, and whilst we are not experts, that may be enough to serve some countries. So no, Costco is not perfect. Perhaps we should own eBay as well.

What are the economics of our purchase of shares in Costco?

Readers that don't enjoy sweating the maths can resume at the next paragraph. Those that like a work-out, read on. Analysis of the annual report (disgraceful lack of colour pictures) reveals that revenues of U\$47.2bn (year to August 2004) represented a 12% mark up on "merchandising costs" and left enough to pay for operating costs (SG&A) of 9.8% of sales (one third of the hi-lo supermarkets). Profits from retailing are therefore around U\$456m per annum to which one should add the membership fees of U\$961m = U\$1.41bn, pre-taxes. Taxes approximate depreciation most years, so pre-tax income equates to gross cash flow before maintenance capex which at around U\$250m per annum implies around U\$1.17bn in free cash flow as a cash cow. This compares to a fixed asset base of company owned real estate of U\$9.6bn (depreciated value U\$7.3bn). Working capital is "supplier funded" and means that the U\$1.17bn free cash flow represents a yield of around 12% on fixed assets. A bear argument is that if the real estate was leased, free cash flow would be nought: this looks right but may miss two things: (1) Rents provide a return to their owners, not just break even on the cost of capital and (2) The store base is under-earning, perhaps significantly. Evidence for this is as follows: revenue per store at the oldest stores is twice this year's new openings, revenues per store at the oldest stores are still rising at 3 to 4% per annum, costs per new store suffer from low capacity utilisation of warehouses, and penetration in California is six times US State average. Store growth will be around 5% per annum and management confess to "always under-estimating saturation": in LA post the merger with Price Club in 1993 they thought 31 stores were too many for the market, but today there are 36. Likewise, in Seattle and Alaska the penetration of cards (membership) is 65% of households (gosh) but in most markets it is below 10%. Note also that one third of the store base remains in California, and almost half on the West Coast. This is a very young franchise. Half of the store base is over ten years old and earns 65% of the revenues whilst using approximately 40% of the asset base. What this means is that the oldest stores earn around 16.5% on assets and the youngest earn 6%. In other words, there is an approximate 50% rise in aggregate profits to come as the store base matures (4% growth per annum), plus same store sales growth at the mature stores (approx. 4% per annum) implying 8% growth before new store openings, which will add 5%

to the store base and can easily be funded through free cash flow. This suggests normalised growth of 13%, and I don't think it is a stretch.

How do we think about valuation? There is a range of possible outcomes for the business, some are more likely than others and, in our mind, they have various probabilities attached. What we present below is our assessment of central value for Costco, but you should bear in mind that it is not the only value for Costco. Our average purchase price of U\$39 per share (a blend of U\$30 per share when the Partnership was small, and U\$40 per share following the draw-down of the Nomad subscription queue in the summer) discounts modest growth of 5 to 6% per annum and is too low for a business that will be pushed not to grow earnings 10% per annum. A price of U\$43 per share discounts 7% growth and U\$85 to U\$90 per share 15% growth. There is a very real possibility that the business could be priced to discount growth of 10% which would imply a price of U\$62 per share today (and that price should rise by our 10% discount rate per annum). If it takes five years for the shares to converge on a price which discounts 10% growth per annum, then the shares would need to rise by 20% per annum from our average purchase price of U\$39 per share.

Such a gain would add around 2% per annum to Partnership assets. And it is this that makes me think the weighting in the portfolio is too small. If Dell is the appropriate model for Costco, then the probability of failure is lower than for most growth stocks. It is lower again when one considers self-funded, as opposed to, rented growth. And lower again when one considers the fixity of mark up. To a far greater extent than for many businesses the company controls its own destiny. So, what attracted us to Costco is the predictability of outcome: we don't think it is going to fail for many years. But is a 2% gain per annum optimal? If one applies the Kelly criterion (discussed in the last letter) the weighting should be much higher. So already your manager may have made his first mistake investing in Costco. From not buying enough. Perhaps I will get my opportunity to make amends.

So, the consensus has it that Costco is a low margin, expensive retailer with a cost problem. That is certainly one description. In our judgement it is a cost disciplined, intellectually honest, high product integrity, perpetual motion machine trading at a discount to value. The weighting in the Partnership may be too small, but even so as the description of the business migrates in the minds of the average investor from the former to the latter, I think we will do quite well.

A Short Word on thinking about Business Values as opposed to Stock Prices

We go through this analytical process with each investment and have expressed our thoughts on Costco here to help illustrate that transient stock price quotations mean little to us (except as an opportunity set for incremental capital). And they should mean little to you. Ignore Nomad's performance so far. We own shares for multi-year periods and so our continued investment success has far more to do with the economics of the underlying businesses than it has to do with their last share price quote. In the last year or three, share price quotes happen to have been in our favour and they flatter your manager's input. You should not always expect this to be the case. There is no reason why business values and share prices should move hand in glove. You should expect that there will be a time when prices, and Nomad's performance, significantly lags the performance of our underlying businesses. It is then that we will ask you to be contrarian and invest more.

How big is Nomad?

There is no getting around it, Nomad is stapled to a fund management organisation three hundred times its size. This was important for Nomad's genesis, and I wonder if it would have survived this long if truly independent. But it is a problem also. Particularly when picking stocks. This is because your manager wears two hats, that of analyst to the main Marathon funds, and that of Portfolio Manager to Nomad. The problem comes when an order for Nomad is aggregated with those of the main funds. Then Nomad, whose own size is small, in effect behaves as if it was a U\$30bn fund (Marathon's total assets under management). This is not ideal, but it is hard to devise a system which does not amount to a worse outcome for one party or the other. We struggle with a satisfactory system, but you should be under no illusion that Nomad's returns, such as they are, are a product of its size alone. We look like a mouse but move like an elephant. It is not a good combination, but it is what it is.

Thank you

We don't write to you that often, as measured by number of letters per annum. But the sum of the letters we write amounts to around ten per stock holding period (two annual letters times five years). On this measure we may be more communicative than many investors who write more often, but trade shares more frequently still. Even so, we like the balance as it is, and are hesitant to fall into "say-something" territory. We are very conscious that investors in the Partnership have reciprocated and allowed us to get on with our job of roaming the globe looking for value. Thank you.

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

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

...back to the annual reports.

Yours sincerely

Nicholas Sleep

Appendix

Introduction to the Global Investment Review, September 2004.

"...this is a superpower in error-causing psychological tendency: bias from consistency and commitment tendency, including the tendency to avoid or promptly resolve cognitive dissonance. Includes the self-confirmatory tendency of all conclusions, particularly

expressed conclusions, and with a special persistence for conclusions that are hard-won”.

Charles T. Munger, speech at Harvard Law School, estimated date June 1995

It is not uncommon for plan sponsors and other clients to ask their fund managers to discuss their latest stock purchases. Perhaps the supposition is that these are the investments on which the manager is most bullish. Perhaps it is a test of conviction. Perhaps the client is looking for a tip, who knows? No matter how good the relationship between fund manager and client there is inevitably a bias at least to defend and at worse promote the purchase decision. We have all done this to some extent. It's only natural; the manager has made the decision to invest and is talking to the client, how can he not be upbeat? Promotion is one thing, and we can all adjust more or less for its effects, decades of company visits have honed that particular skill, but that is not the issue at hand. The issue is whether, in trying to convince the client of the merits of the case, the manager convinces himself. The danger is highlighted by Munger in the passage below:

“And of course, if you make public disclosure of your conclusions, you're pounding into your own head. Many of these students that are screaming at us, they aren't convincing us, but they are forming mental chains for themselves, because what they are shouting out, they are pounding in. And I think that educational institutions that create a climate where too much of that goes on are...in a fundamental sense, they are irresponsible institutions”.

It is for this reason that in its purest form a fund management company's sales function (whose basic technique is to “shout out and pound in”) can be counter-productive. And it is why the most successful salesmen (as measured by commissions earned over the short-term) are frequently void of rooted-in-reality objective thinking, such as is vital for good long-term investment performance. Either fund management companies are investment companies or marketing companies. Not both. At Marathon we think we understand this conflict but even we struggle, and we make no claim to maximise both functions. The fact is that sales and size are the two main detractors of long-term performance, after inability. To paraphrase Mr. Buffett, should you come across individuals suggesting otherwise our advice is watch their noses, for signs of abnormal growth.

This is not to say that investors do not have the right to question their managers about stock picking – far from it. But both parties must be aware of what they are doing. Our thinking is that fund managers should have absolute conviction on the philosophy and methodology of their investment principles, providing of course that those principles reflect reality. But they should be circumspect about expressing these tenets as they relate to individual stocks. Evangelism is not healthy. The reason is that, whilst fund managers have it in their powers to control the way they think, they are unable to control how their companies behave. Businesses evolve, companies make mistakes, business managers change their minds, share prices depart from reality – the investment manager can control none of these factors but needs to assess objectively each one for the risk of misanalysis. The issue is: in publicly disclosing his stock picking commitments, does the investment manager subtly and no doubt subconsciously rob himself of his objectivity and the option to change his mind? To deny this takes place seems foolhardy. The question is, how many recognise the risk of dysfunctionality, and adjust their behaviour? Certainly, those consultants and plan sponsors that insist upon frequent, detailed, blow-by-blow reporting may be surprised to learn that their seemingly reasonable request risks being counterproductive. Consultant meetings, which aggressively bear down on the microeconomics of an individual business, seem designed to form mental chains that neither

side needs to bear. But where does that leave monthly reporting, quarterly reporting, annual reporting, and even this publication?

Fund management errors are not the only ones that result from over-promotion activity. Quarterly, or even monthly, client reporting routinely marks fund management performance to market and these result snapshots acquire an extra validity, simply by virtue of their being reported. At Marathon a full holding cycle can exceed 5 years, so any quarter individually considered could be poor without affecting long-term outcomes. For those keen on monthly results there will be 60 such data points in a full holding cycle. These data points, in the hands of an inexperienced investment committee, could be misconstrued or worse. After all, most of Marathon's client termination events occurred after, rather than before, a period of underperformance. According to Munger, it is a common psychological tendency that people overweigh the vivid evidence (or recent experiences). This is clearly what can happen via the mark-to-market effects of quarterly reporting. The "Pavlovian" association of poor short-term results with long-term incompetence and confusion between the two can lead to disastrous decisions. Today this risk is greater than ever because, relative to history, consistency of investment performance is an attribute prized almost above all others in some parts of our industry.

At a New York cocktail party populated by investment professionals this author clumsily asked one fund manager what his largest holding was. My acquaintance's response was to decline to answer for reasons that this essay makes plain. His response seemed rude in a social setting, at least to this author, but having thought about the issues for about a year, it was perhaps the highest quality answer he could have made. He certainly understood elementary psychology.

Perpetual Growth Machine

While Costco shares aren't cheap, value investor Nicholas Sleep shares some fascinating insights about the company and makes an excellent case for its long-term prospects.

Value investors have long been intrigued by Costco Wholesale Corp. It has a fabulous long-term record of steady growth, it's old-school in its management and compensation practices, Berkshire Hathaway's Charlie Munger is on the board – plus, any bargain hunter loves to shop there. Not so many value investors own the stock, however, in part because it has extremely low margins – less than 2% after tax – and the stock rarely looks cheap, trading today at 25x trailing earnings per share.

So we didn't expect anything particularly new when we sat down to read the discussion of Costco in the annual letter of Nicholas Sleep of London's Marathon Asset Management. But Sleep's fresh insights, arguments and analysis – “Mungeresque” in tone and content – persuaded us that Costco's intrinsic value is probably quite a bit higher than we'd thought. We followed up with him to learn more on why he believes, even if it's not a 50-cent dollar, Costco is an outstanding long-term investment.

Customer really is king

Retailers love to boast that the “customer is king,” but none live it like Costco. It starts with how the company negotiates with suppliers. As Sleep notes:

“Costco's key to negotiating terms is that the number of items in a store (SKUs) is fixed at around 4,000, with those suppliers that provide the best value proposition to the consumer winning space on the shop floor. Contrast this to normal industry practice, where the supermarket assumes the role of landlord, auctions space to the highest bidder and pockets the rents (“slotting fees” in industry parlance). Many supermarkets make their money from buying from the supplier. Costco makes money from selling to the consumer.”

Costco fixes its retail prices at a maximum of only 14% over the compa-

ny's cost – with no exceptions. This pricing discipline – even Wal-Mart's mark-ups are around 20% – engenders outstanding customer loyalty. As the company has raised its annual membership fee over time, to \$45, membership renewal rates have barely budged from an enviable 85%.

The real power of Costco's strategy – and the source of its competitive advantage, according to Sleep – is how the benefits of growth are reinvested in the relationship with the consumer. As Costco opens new stores, supplier and other scale cost savings are passed back to customers through even more compet-

INVESTMENT SNAPSHOT

<p>Costco Wholesale Corp. (Nasdaq: COST)</p> <p>Business: Membership warehouse retailer offering members low prices on limited selection of branded and private-label products across multiple product categories. Primary operations in U.S. and Canada.</p> <p>Share Information (@2/17/05):</p> <table border="0" style="width: 100%;"> <tr><td>Price</td><td style="text-align: right;">46.10</td></tr> <tr><td>52-Week Range</td><td style="text-align: right;">35.05 - 50.46</td></tr> <tr><td>Dividend Yield</td><td style="text-align: right;">0.85%</td></tr> <tr><td>Market Cap</td><td style="text-align: right;">\$21.66 billion</td></tr> </table> <p>Short Interest: (@ 1/10/05)</p> <table border="0" style="width: 100%;"> <tr><td>Shares Short/Float</td><td style="text-align: right;">2.47%</td></tr> </table>	Price	46.10	52-Week Range	35.05 - 50.46	Dividend Yield	0.85%	Market Cap	\$21.66 billion	Shares Short/Float	2.47%	<p>Financials (TTM):</p> <table border="0" style="width: 100%;"> <tr><td>Revenue</td><td style="text-align: right;">\$49.16 billion</td></tr> <tr><td>Operating Profit Margin</td><td style="text-align: right;">2.91%</td></tr> <tr><td>Net Profit Margin</td><td style="text-align: right;">1.86%</td></tr> </table> <p>Valuation Metrics: (Current Price vs. TTM)</p> <table border="0" style="width: 100%;"> <thead> <tr> <th></th> <th style="text-align: center;"><u>COST</u></th> <th style="text-align: center;"><u>S&P 500</u></th> </tr> </thead> <tbody> <tr><td>P/E</td><td style="text-align: center;">24.0</td><td style="text-align: center;">23.1</td></tr> <tr><td>P/CF</td><td style="text-align: center;">16.0</td><td style="text-align: center;">13.9</td></tr> </tbody> </table> <p>Largest Institutional Owners:</p> <table border="0" style="width: 100%;"> <thead> <tr> <th>Company</th> <th style="text-align: center;">% Owned (@ 9/30/04)</th> </tr> </thead> <tbody> <tr><td>Davis Selected Advisers</td><td style="text-align: center;">7.86%</td></tr> <tr><td>Barclays Bank Plc</td><td style="text-align: center;">3.64%</td></tr> <tr><td>State Street Corp.</td><td style="text-align: center;">2.73%</td></tr> <tr><td>Capital Guardian Trust Co.</td><td style="text-align: center;">2.32%</td></tr> <tr><td>Vanguard Group</td><td style="text-align: center;">2.18%</td></tr> </tbody> </table>	Revenue	\$49.16 billion	Operating Profit Margin	2.91%	Net Profit Margin	1.86%		<u>COST</u>	<u>S&P 500</u>	P/E	24.0	23.1	P/CF	16.0	13.9	Company	% Owned (@ 9/30/04)	Davis Selected Advisers	7.86%	Barclays Bank Plc	3.64%	State Street Corp.	2.73%	Capital Guardian Trust Co.	2.32%	Vanguard Group	2.18%
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COST PRICE HISTORY

THE BOTTOM LINE

Costco's "perpetual machine" of growth is capable of keeping company revenue and cash flow growing 13% annually, says Nicholas Sleep of London's Marathon Asset Management. If the market price reflected even a 10% growth expectation, he says, COST would trade at \$62, a 34% premium to the current market price.

Sources: Company reports, other publicly available information.

itive prices. Customers then respond to the better prices, driving incremental revenue at both new and old stores. As Sleep writes:

“In the office we have a white board on which we’ve listed the very few investment models that work and that we can understand. Costco is the best example we can find of one of them: scale efficiencies shared with customers. We often ask companies what they

that’s just Wall Street’s obsession with short-term outcomes. The firm could earn Wal-Mart margins by taking pricing up a little and the stock would then trade at 11x earnings, but would it be a better business as a result? We think not, because it might allow the competition to catch up.”

Contributing to margin pressure in recent years has also been a rise in SG&A costs as a percentage of rev-

with Price Club in 1993, Costco thought 31 stores were too many for the market, but today there are 36. Likewise, in Seattle and Alaska, the penetration of membership cards is an astonishing 65% of households, but in most markets it is below 10%.”

All told, Sleep estimates that Costco can conservatively increase revenue and free cash flow by 13% per year into the foreseeable future – 4% from the increasing asset turns of newer stores as they mature, 4% from same-store growth at already-mature stores, and 5% from new stores.

“This is an early life-cycle company whose competitive moat gets deeper as the company gets bigger and the consumer is consistently cut-in on the benefits of the company’s growth,” Sleep says, terming this cycle a “perpetual machine” of growth.

The market, which currently prices Costco shares at around \$46, is not so generous in its growth expectation. Sleep calculates that if Costco shares were priced to reflect just 10% annual growth, the stock would trade at \$62 today. Even at that price he wouldn’t sell, he says, given his expectation for even faster growth.

What could go wrong? Wal-Mart, with Sam’s Club, could mount a sustained direct attack to undercut Costco’s prices. Sleep considers that unlikely, as Costco has shown itself more than capable of competing head-to-head with the discounting giant. The departure of CEO James Sinegal, 68, the architect of Costco’s unique and disciplined culture, could also be a blow. Sleep points out that Sinegal shows no sign of slowing down, and that Costco’s experienced board can be counted on to appoint a worthy successor.

We’ll leave to Marathon’s Nicholas Sleep the final word on Costco: “The consensus has it that Costco is a low-margin retailer with an expensive stock and a cost problem. That is certainly one description. But in our judgment it is a cost-disciplined, intellectually honest, high-product-integrity, perpetual motion machine trading at a discount to value.” VII

PRIVILEGES OF MEMBERSHIP



Costco’s membership-only model helps foster a unique relationship with its customers. People shop there because it’s Costco, not because it stocks Pepsi or Pampers. As Costco has raised its basic annual membership fee over time, to \$45 currently, membership renewal rates have barely budged from an enviable 85%.

would do with windfall profits, and almost no one replies ‘give it back to customers’. How would that go down with Wall Street? That is why competing with Costco is so hard to do. The firm is not interested in today’s static assessment of performance. It is managing the business to raise the probability of long-term success.”

By sharing the cost savings of growth, Costco earns revenues per square foot – around \$830 – that are the envy of the industry. Wal-Mart’s Sam’s Club checks in at around \$500 per square foot, while BJ’s Wholesale Club is about \$400. Even more importantly, Sleep estimates that mature Costco stores – open at least five years – generate revenue of over \$1,000 per square foot.

Margin trouble?

Costco’s pricing discipline, by definition, keeps margins low – at 1.9%, they are roughly half those of Wal-Mart (3.6%) and Target (4.1%). Sleep argues that Wall Street’s focus on margins is short sighted:

“True, the company has low margins, but that’s the point. The firm is deferring profits today in order to extend the life of the franchise. Of course Wall Street would love profits today, but

enues, fueled in large part by spending on a new warehousing and distribution system and rising employee wages and benefits. A sign of trouble? No, explains Sleep: “We clearly differentiate between ‘good’ and ‘bad’ SG&A spending,” he says. “In both of these cases, Costco is investing in areas critical to its growth.” With the new warehousing system in place, efficiency gains will start showing up in the financials this year. And the slightly higher wage base helps Costco retain its employees twice as long as competitors do, which Sleep sees as positively impacting customer service and contributing to its very high customer retention.

Still an early life-cycle company

Even with annual sales of nearly \$50 billion, Sleep makes a compelling case for Costco as a growth company, through geographic expansion, increased market penetration, and the virtuous cycle of growth in maturing-store asset turns as scale efficiencies result in even lower prices.

“One-third of the store base remains in California, and almost half on the West Coast. Management always confesses to underestimating saturation. In Los Angeles, for example, after merging