

## Nomad Investment Partnership

### Interim Letter For the period ended June 30th, 2005

To June 30th, 2005	<u>Nomad Investment Partnership</u>	<u>MSCI All Country World Index (net) US\$</u>
6 months	+2.4%	-0.3%
One year	+26.2%	+11.2%
Two years	+78.1%	+38.3%
Three years	+118.7%	+35.4%
Since inception (Sept. 10 <sup>th</sup> 2001)	+150.5%	+28.9%
Annualized since inception		
Before performance fees	+27.1%	+6.9%
After performance fees	+22.6%	+6.9%

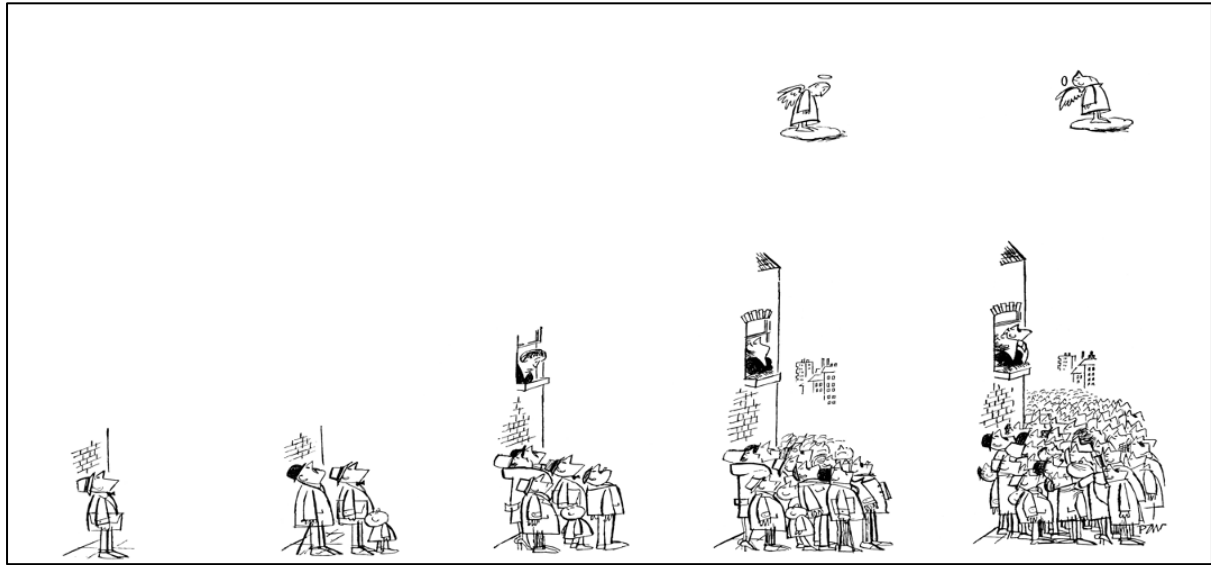
The figures above are presented on a cumulative basis (for the “A” shares, after management fees and before performance fees). Below the same results are presented in discrete annual increments. In our opinion, it is the upper table that is most useful in assessing long-term investment performance (see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

To June 30th. 2005:	<u>Nomad Investment Partnership</u>	<u>MSCI All Country World Index (net) US\$</u>
6 months	+2.4%	-0.3%
2004	+22.1%	+15.2%
2003	+79.6%	+34.0%
2002	+1.3%	-19.3%
2001 (inception Sept. 10 <sup>th</sup> 2001)	+10.1%	+3.9%

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When we said we expect to get rich slowly, we did not quite have the first half of 2005 in mind. Even so, a 2% gain is at least in the right direction and is a little better than the alternatives represented by global stock market indices. But more important, the value of the companies in which we have invested rose by more than 2% and we were able to add to some of the cheapest investments with the effect that, by our analysis, the price to value ratio of the Partnership declined from the low seventy cents on the dollar at the end of the year, to the upper sixty cents. A rational analysis would conclude that we are richer twice over, once from the gain in the price of the Partnership to date, and second from the rise in the value of the Partnership compared to its price.

It is a constant feature of the investment landscape that people applaud recent gains when they should be thinking more about the future. We all do this to some extent. We all like rewards and like to be associated with success. And it is hard not to be drawn toward the crowd. One of our favourite cartoons, carried by Punch in the 1970s (and reproduced in the book “Influence: The Psychology of Persuasion” by Robert Cialdini some years later) makes the point.



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Following what everyone else is doing may be hard to resist, but it is also unlikely to be associated with good investment results. Zak and I concentrate on the price to value ratio of the Partnership and ignore its performance as much as is practical, and we would encourage you to do the same. In our opinion you should be more pleased with the improvement in the price to value ratio of the Partnership than the gain in the price of the Partnership this year. That's easy to say when results have been reasonable. But it would feel quite different if the Partnership had declined in price instead. Unfortunately, nature does not always help us to think rationally. Psychologists (McClure, Laibson, Loewenstein and Cohen 2004) have found that the brain perceives immediate rewards differently to deferred rewards because two different parts of the brain are involved. Immediate gains are perceived positively compared to larger deferred gains as the limbic (survival) system has the ability to over-ride the fronto-parietal (analytical) system. Interestingly, stress induces this over-ride, and of course, money induces stress. So, the more stressed we are, the more we value short-term outcomes! This is not without reason, for if starving is a real possibility, a meal today is more important than a feast in a week's time, and the brain's wiring reflects that survival bias. Such notions are embedded in popular phrases such as "a bird in the hand is worth two in the bush". But at Nomad we try to be more analytical: it is the two birds in the bush we are concerned with and how they compare to the bird in the hand. In our opinion, today, the birds in the bush are around 47% (68c/100c) bigger than the bird in the hand. This compares with only around 37% (73c/100c) bigger at the end of last year. The Partnership is up this year, but you can see that it also does not mean very much compared to the deferred gains. It is price to value that's important.

### Competitive Advantage

As a young(ish) man there is something slightly depressing about thinking things through for a while, arriving at a somewhat reasoned conclusion only to find that others have been there before, and years earlier. In some respects, we are fifty years behind Buffett, but that's ok so long as the average investor is at least fifty-one years behind! I would estimate we were some way behind Bill Miller as well, as evidenced by his recent speech to students at the Columbia

Business School in which he posed the question – what is your competitive advantage in investing? It was the elegance of the answer that grabbed us. Broadly Bill Miller argued that 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). Sustainable competitive advantages are usually a product of analytical and or psychological factors, and the overwhelming advantage with regard to Nomad is the patience of the investor base and the alignment of that disposition with the analytical and psychological traits of your manager. It simply would not work otherwise. In the investment objective section of the Nomad prospectus, we say that our job is to “*pass custody [of your investment] over at the right price and to the right people*” and that “*the approach will require patience*”. That’s what investing is, at least for us. But let me return to the speech for a moment.

*“Think of how the future will be different from the past. Most people default to the directions and trends that they are currently observing...The important thing is that most things change. In longer term projections, Peter Bernstein tells us, that cone of uncertainty gets wider as time goes out. What are the chances that IBM will be bankrupt tomorrow morning? Probably none. A year from now? Five years from now? What about one hundred years from now? The point being that the possibilities increase as time goes out. So, what you are trying to do as an investor is exploit the fact that fewer things will happen than can happen. So, you are trying to figure out how that probability distribution works and stay in the middle of what will happen. The market has to worry about all the things that can happen.”*

To repeat: “*what you are trying to do as an investor is exploit the fact that fewer things will happen than can happen*”. That is exactly what we are trying to do. We spend a considerable portion of our waking hours thinking about how company behaviour can make the future more predictable and lower the risk of investment. Costco’s obsession with sharing scale benefits with the customer makes that company’s future much more predictable and less risky than the average business and that is why it is our largest holding. Our smaller holdings are less predictable but in certain circumstances could do much better as investments. We are just not sure that they will as their “*cone of uncertainty*” has a much greater radius than at Costco. Bill Miller got there years ago. We are just getting there today.

### The Robustness Ratio

At the risk of mildly boring some readers, it may be worth completing the analysis of Costco here by introducing the robustness ratio. (Avid readers will recognise that this ratio was introduced in a Global Investment Review, contained in the appendix to this letter). The robustness ratio is a framework we use to help think about the size of the moat around a company. It is the amount of money a customer saves compared to the amount earned by shareholders. This ratio is more appropriate for some companies than others, the prime criteria being that the customer proposition is based on price, such as exists at Costco, as opposed to an advertising-reinforced purchase such as Nike trainers. In the Berkshire Hathaway annual report this year, the Chairman tells us that Geico policyholders saved US\$1bn on their policies compared to the next cheapest carrier. It also turns out that Geico earned around US\$1bn as well. So that’s one dollar saving to the customers and one dollar retained for shareholders. At Costco we think the customer saving is around five dollars, compared to shopping at most supermarkets, for every dollar retained by the company.

So what? Well, it is probably fair to argue that the higher the ratio, the harder it would be to compete against Costco on a like for like basis. Also, a higher ratio may imply a somewhat inequitable distribution of system rewards between customer and shareholder than a lower ratio. There is a tension here between the size of the moat on the one hand and the distribution of rewards on the other. In the last few years, the pendulum has swung in favour of the customer, with the result that the stock is cheap enough to be vulnerable to a leveraged buy-out (completely unobserved by Wall Street where only one in five analysts rate the stock a buy, which solves for the shares being cheap enough to fund a buy out in the first place – the two are of course linked). This is a huge source of risk for current shareholders since being taken out at a low-price amounts to theft. It's that serious, and you can rely upon us to see it that way. We think the board understands this, and the way to bet is that the pendulum will swing back in favour of the shareholders over the next few years. Look around you. How many companies save five dollars for their customers for every one dollar they keep?

It does not happen in the investment industry where fees can be levied regardless of performance – that's not much of a robustness ratio and does not take into account the asymmetry of the risks involved. You can't lose money shopping at Costco, but you can investing. This would argue that robustness ratios need to be much higher in the investment industry than for normal businesses to compensate for the risks involved. We have tried to some extent to account for this asymmetry through Nomad's six percent performance hurdle. It is not perfect, there is no science behind the number, although it is meant to represent a generous proxy for deposit rates. And besides having a hurdle rate helps us sleep at night.

#### Zimbabwe as an Example of a Second Investment Model.

We have begun making some investments in Zimbabwe and wrote about the background to these in a recent Global Investment Review (also contained in the appendix). The investment case relies upon extreme undervaluation compared to normalised values, so much so that a wait of ten years for normalisation would still yield wonderful results. It makes little sense to discuss stocks we may or are buying (Costco is likely to be a rare exception in this regard) but I can illustrate the investment case by describing Zimcem. This is the country's largest cement producer (after the local division of Pretoria Portland Cement), with around 700,000 tons of cement capacity and a replacement cost of around U\$70 to U\$100m. The firm has no debt and business conditions are awful (general inflation exceeds cement price inflation and product demand is low) but the company is priced on the Harare stock exchange at one seventieth (1/70th!) of its replacement cost.

Why is this relevant? So far, we have only discussed one model we use to pick good investments which we call "scale efficiencies shared" as evidenced by Costco (and to a lesser extent Amazon.com). We have little more than a handful of distinct investment models, which overlap to some extent, and Zimcem is a good example of a second model namely, "deep discount to replacement cost with latent pricing power". Indeed, these two models combined can be used to describe around 45% of total Partnership assets. It was this model that led to many investments during the Asian crisis (such as Siam Cement which has risen twenty-fold from the trough in eight years) and to neighbouring South Africa where Pretoria Portland Cement could be bought at a price of U\$20 per ton of capacity in 1998 and is now valued at U\$180 per ton. The model is premised upon the observation that the business needs to replace its assets and will require prices which 1. fund the capex, and 2. economically justify the spending. Either that or Zimbabwe will have to go without cement or import from abroad (tricky for this land locked country). In any event, provided discretionary capital is not

invested to exacerbate the situation, the supply side remains muted (industry capex is zero) and the business is not nationalised, then the shares ought to do well, in time.

This last point, along with other confiscation events, does not have a zero probability, and is the main reason our investments in the country will be modest in size. Even if we were able to secure all the shares we desire (which we seem incapable of doing) it is unlikely that the total investment would be much more than a few percent of the Partnership at cost. There is no a priori reason why Zimbabwean businesses should not trade at a premium to replacement cost. Just over the northern border Zambia's dominant cement company is now valued at a premium to replacement cost following recovery in the economy after years of mismanagement. In Zimbabwe this may require "*regime change*", or even regime changes. Perhaps the investment case rests in your manager being fifty years younger than Bob Mugabe.

### The Pricing of Shares in Zimbabwe

The official exchange rate at the time of writing is Z\$9,100 to the US\$1. The unofficial, street rate is around Z\$17,000 to the US\$1. In other words, the Central Bank values its own currency at over twice the price set by the public with the effect that money entering the country via the Central Bank buys approximately half as much as at the street rate. Fortunately, there is an alternative to the Central Bank for foreign investors, which is to purchase Old Mutual shares in Johannesburg, re-register the same shares in Harare and then sell the shares in Harare. This we have done. But it creates a problem in valuing our Zimbabwean shares as Bloomberg, Reuters and the other main sources of currency prices use feeds from the Central Bank. In other words, if we solely relied upon the official rate of exchange our investments would immediately show an 86% gain. This gain is entirely illusory. Were we to reverse the process by re-registering the shares in Johannesburg and selling our stock there, the proceeds would approximate the money we first put in (minus frictional costs and any change in the price of Old Mutual shares). The only way we could realise the 86% gain would be to present our Zim dollars to the Central Bank and ask for US dollars at a rate of Z\$9,100. And we would be waiting for Godot. There are almost no transactions taking place at the Central Bank and priority is given to trade and working capital requirements, not foreign investment portfolios. So, we could try, but I don't think it is prudent to value the portfolio on the basis of a warm response from the Zimbabwean Central Bank. So, our solution has been to value the Zimbabwean investments at the rate of exchange implied by the Old Mutual share price in Harare divided by the price of exactly the same share in Johannesburg (note that the shares are fungible in both directions). The effect is to approximate the street rate of exchange and remove the artificial book gain implied by the official exchange rate, and hopefully the worst of any pricing distortions should be minimised as a result. This is a somewhat unusual solution, but one that I think is fair, and the auditors, board and administrators have decided to agree with my methodology. Please do call however, if all is not clear.

*"Any year that you don't destroy one of your best loved ideas is probably a wasted year"*, Charles T. Munger.

In January this year, the market town of Carlisle (located between the English Lake District and the border with Scotland and incidentally home to your manager's family-in-law) was flooded when the River Eden broke its banks. Parts of the city center were under many feet of water and residents were shown on national TV being evacuated from roof tops by

helicopter. As the water receded the city slowly returned to normal, although the damage remained extensive, and included the traffic light system at Hardwicke Circus, a junction of seven roads controlled by a series of traffic lights dotted throughout approaching roads and a central roundabout. Although the lights remained out of use, the authorities opened the roads and trusted the residents to drive with care. Soon afterwards, drivers began to suspect that the traffic flowed better through the complex junction without the traffic lights than before, and in March this year the City Council began a trial in which the lights were covered up, and drivers left to get on with it. What they found confirmed public suspicions, the speed of traffic through the intersection had indeed risen, and better still, it appeared that the number of accidents may actually have fallen as well. What they found was entirely contrary to accepted wisdom in council planning, that the roundabout was faster and may also be safer without the traffic lights! Ayn Rand would recognise what was happening, as may members of the Santa Fe Institute (which recently published a study entitled “*How Individuals Learn to Take Turns: Emergence of Alternating Cooperation in a Congestion Game and the Prisoner’s Dilemma*”). The point is that, often, if one removes the rules, and instead ask people to think for themselves, the system works better.

We criticise hedge funds for their fee scales and short investment time frames, but they have a point when it comes to investment rules and certain regulations. Traditional investment management can become heavily burdened by bureaucracy, compliance and corrupted by marketing expediency. These business forces can work at the expense of the investment process, and the trick for any growing investment firm is not to sap the life out of the investment team through stapling them to the bureaucratic equivalent of the US Department of Agriculture. We think of ourselves as reasonably entrepreneurial, but even we suffer to some extent from this culture-drift. The solution is not hard to come by. What is required is for people to behave in such a way that, in the words of Charlie Munger, one builds “*a seamless web of deserved trust*”. The operative word is “*deserved*”. The problem is that rules do not require people to think, and how are people to deserve trust if first they don’t think? Degenerative spirals of behaviour do not build good results (or fast roundabouts), but that is where the industry is going, and it is a destination we will all do well to avoid.

We try not to be too hard and fast about rules. In previous letters we have quoted H.O. Hirt, founder of Erie Indemnity, and it would be a shame not to do so again. Hirt posted the following notice to staff:

**“RULES**  
*Are for INFANTS, INCOMPETENTS,*  
**INCARCERATED CRIMINALS and IMBECILES**  
*- NONE of WHOM should have any place in the*  
**ERIE FAMILY.”**

Even so a few rules end up slipping in overtime and need to be viewed with great suspicion. One was that a low share price was better than a high share price, all other things being equal, which proved unwise when the low market capitalisation undermined shareholders’ bargaining position in the recapitalisation of Conesco a few years ago. This year we shall have to discard another strongly held bias which is that high inside ownership is a good thing. This too is not always helpful, as shareholders in Northwest Airlines are finding out. In this instance the unions appear to reason that management (who are the largest group of shareholders) will not risk placing the company in bankruptcy and are holding out for the last dollar in negotiations. Oddly here, high inside ownership is hindering the process that would

lead to a more viable airline. Who would have thought that a low share price and high inside ownership could be bearish? But they can. I wonder what other “*best loved ideas*” we will need to rethink in the coming years.

### 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.

To date we have appended a copy of the schedule of investments with our letters. This is not necessarily in Partners’ interests. There are powerful psychological reasons for not doing so associated with commitment and consistency tendency (covered in previous letters), and then there is the issue of others piggy backing on ideas. This is not so much a problem today as few care what we do and the Partnership is small, but it could become an issue should the Partnership grow. Only the other week I received a request from a London based hedge fund (with a reputation for short term punts) for another copy of our Global Investment Review. Think of that! We did not know they had one copy, and they were casually asking for another? What are they going to do with the information? If Partners wish to circulate our schedule of investments to others, then they must understand that their actions are contrary to their (and our) economic interests in Nomad. The same cannot be said for those that are not invested. So, if you are a Partner then you will find a copy of the schedule of investments attached to this letter, and we ask you to use that information wisely.

On the administration side, please do call Daiwa Securities Trust and Banking in Dublin with your enquiries (+353 1603 9921). The 2004 Nomad annual report and accounts were mailed to shareholders in May, considerably earlier than last year. I am also aware that there have been issues with the timely receipt of statements. We are on to it, and nag Daiwa constantly. 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 Partners with basic performance and statement enquiries.

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

...back to the company annual reports.

Yours sincerely

Nicholas Sleep

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In this article, 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.

## Appendix 1

“Measuring the Moat”. Global Investment Review, May 2005.

The phrase “business moat” is often banded around when discussing the absolute or comparative strength of a franchise. That there are businesses with defensible positions is of little doubt; but what these discussions often lack is any empirical method by which moat size or longevity can be measured, compared or monitored over time. In addition, stock investors (particularly those who, for their sins, have been labelled growth investors) face an important task, namely, how can one recognise the creation of a business moat well in advance of its value being discounted in the stock market? While reading the 2005 Berkshire Hathaway Annual Report, one paragraph stood out for us as Warren Buffett referred in passing to the division of operating and underwriting cost savings at motor insurer GEICO. These “benefits” were divided between shareholders, policy holders and employees and the statistics spelt out in some detail. This simple breakdown struck a chord with our continuing analysis of Costco, a significant Marathon shareholding in the United States. What is becoming clearer in our minds is that one can empirically measure the strength of a business franchise through such an analysis of the division of benefits, what we have come to call its “robustness ratio”.

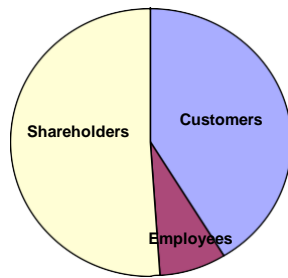
First, a brief recap of Buffett’s comments with respect to GEICO.

*“Indeed, GEICO delivers all of its constituents major benefits: In 2004 its customers saved \$1 billion or so compared to what they would otherwise have paid for coverage, its associates earned a \$191 million profit-sharing bonus that averaged 24.3% of salary, and its owner – that’s us – enjoyed excellent financial returns.”*

Source: Berkshire Hathaway, 2005 Annual Report

These financial returns, measured in terms of an underwriting profit, were close to US\$1 billion pre-tax last year but this excludes the investment returns earned on the US\$5-6 billion of float generated by GEICO throughout the year (on which we may want to assign subjectively a return of 5%). These benefits, of course, only accrue to the three groups as a result of scale (if one assumes that underwriting skill can be developed or acquired). This allows us to construct a pie chart (Figure 1) representing how these scale economies are shared. The robustness ratio, defined as the combined distribution to customers and employees (through a profit share or the like) divided by the distribution to shareholders, is in GEICO’s case about 1:1.

Figure 1: GEICO: A fair division of spoils

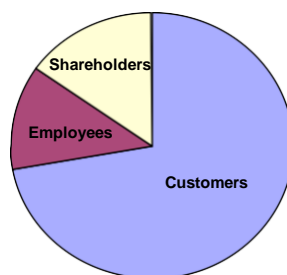


Source: Marathon

This picture, of course, represents a snapshot; just as important is how this division of benefits develops over time, a subject we will touch on later. Tracking back to Costco, we are able to construct a similar pie chart using the following facts and figures. On average, a Costco cardholder (as opposed to household; on average each household holds 2 cards) spends US\$1,100 per year in the store. Costco spends US\$980 at cost to supply these goods which, if one assumes similar buying power and a comparable basket make up, would cost US\$1,300 at a competing supermarket such as Kroger or US\$1,250 at Wal-Mart (gross margins of 26% and 23% respectively, compared with 11% at Costco). Now these comparisons are not quite so straightforward as Costco’s members must “pay to play”, currently US\$23 per cardholder on average, and this annual fee is fixed whatever a cardholder spends (this implies the distribution of customer savings is not even across the membership base, a fascinating influence on customer behaviour and itself worthy of analysis). But we can estimate that, on average, a Costco cardholder saves somewhere in the region of US\$175 per year by shopping at Costco in return for an annual fee investment of US\$23, or a net gain in the region of US\$150 per cardholder per year.

Now we turn to employees. From recent management meetings, we have gained some clarity on the difference between Costco’s wage/benefit scales and those available from competitors (this difference being the functional equivalent of GEICO’s profit related bonus). If we assume that 70% of Costco’s SG&A is made up of wages/benefits and that Costco’s wage/benefit scales are 55% higher than the competition, then Costco, in a sense, “overpays” its employees to the tune of US\$1.1bn per year, or US\$26 per cardholder per year. Finally, shareholders. On Wall Street, there has been a suspicion that the return to shareholders has been a “residual” after customers and employees have been well cared for. And at US\$32 per cardholder pre-tax, or 15% of the distributable pie, the shareholders’ share is not in the same league as at GEICO. In any case, Costco’s pie chart (Figure 2) looks something like this, and its robustness ratio is of the order of 5:1.

Figure 2: Happiness is... being a Costco customer.



Source: Marathon

While the standard Wall Street view is that such a picture is retailing's equivalent of collectivism, in our view it represents an excitingly wide and unassailable moat. While "unassailable" may seem like a bold assertion, an analysis of the limited disclosure of financials at Sam's Club suggests that the size of the distribution to Costco customers is so large that any attempt to match its prices would cost Sam's somewhere in the region of US\$1.4 billion annually while matching Costco's pay scales would set them back another US\$750million. Such numbers are not insignificant even to Wal-Mart which last year earned net profits of US\$9 billion. Such a chasm of competitiveness is, of course, difficult to capture using traditional analytical tools. After all, both Costco and Sam's Club generate thin profit margins, both are growing revenues, and both are placing enormous pressure on traditional supermarkets and smaller wholesale clubs. But it seems inevitable that the long-term outcome for the two businesses will be significantly different particularly as measured by the growth of *revenue per unit of selling space* over the long-term. And Costco's business model dictates that this competitive gap should expand over time as a fall in Costco's relative asset intensity and increasing buying power will lead to greater scale efficiencies, which in turn are handed back to the customer in the form of lower prices. Game over.

Having come to such a robust conclusion we should offer a word of warning. Both Costco and GEICO have strong corporate cultures, embedded in which is the inspirational thought that the rational (and equitable?) division of benefits is the only appropriate way of ensuring these businesses will *grow* in strength as they grow in size. And while culture slippage at GEICO is hard to envisage, courtesy of its place in the Berkshire Hathaway corporate museum, the same may not be true of Costco. An unpleasant output of this apparent disregard for shareholder returns is that the Costco share price is broadly unchanged on levels reached six years ago. And Wall Street is, by all accounts, not happy. Even a culture built up over forty years is not immune to this pressure and Costco's senior management team are beginning to feel the heat. Indications are that the company is gently tinkering with the division of benefits in favour of shareholders in part to satisfy the quarterly EPS junkies but also in recognition that an asset-rich Costco represents an attractive target for private equity buyers. Long-term shareholders should view such slippage as worrying and unnecessary. In our view, the correct response to a six-year share price famine is for the company to use its balance sheet to buy back shares at prevailing prices and allow the long-term growth in free cash flow per share (an inescapable function of steady margins, falling asset intensity, growing revenues and a shrinking base of shares outstanding) to translate into a higher share price over time. The argument for allowing the robustness ratio to drift gently ignores the impact on future generations of managers who will have been presented with a precedent for tweaking the model when expedient. We do not presume to lecture the remarkable managers at Costco on what the appropriate robustness ratio should be, just that any changes to the division of benefits should be made for purely competitive reasons and not driven by a wish to pander to investors.

We wouldn't wish readers to come away with the view that robustness ratios are a numerical magic bullet to measure moats. They are plainly not. There are numerous reasons why Costco's 5:1 and GEICO's 1:1 ratios may be equally powerful barriers to competition and why a ratio even finer than that at GEICO may be perfectly sufficient to repel competitive marauders. Also, falling ratios are not necessarily a sign of shrinking moats, just that moats are not being made as wide as they could be. Where robustness comes into its own is in identifying companies, such as Costco, which may be under-earning when compared to their potential. This generates super long-term investment opportunities for those willing to look beyond reported earnings.

Early in a firm's development it makes sense to reward customers disproportionately as customer referrals and repeat business are so essential to the development of a valuable franchise. With maturity this bias can be reduced, and shareholders can reasonably take a greater slice of the pie. Too much, however, and the moat is drained with negative consequences for longevity. The temptations are enormous because capital markets will reward profiteering. There are many examples of companies which "harvest" excessively, when perhaps they should focus on longevity. This may have been what happened at Coca Cola which has leant excessively on bottlers, or Gillette where advertising has been cut, or even at Home Depot which has boosted gross margins in recent years. Shareholders often suffer a double whammy as highly rated companies enter "growth purgatory", because growth slows just at the time when shareholders spot their misanalysis of reported profitability.

## Appendix 2

"Zimbabwe". Global Investment Review, February 2005.

*"That's what brothers are for, brother."*

Gil Scott-Heron, "Small Talk at 125<sup>th</sup> and Lenox"

Some commentators believe that the current condition of stock markets is now more dangerous than the bubble of the late 1990s. Then at least there was the anti-bubble formed from cheap low growth companies. Today there is no Zen-like symmetry to stock prices; and there are few obvious pockets of undervaluation for the contrarian. A cheer all round then for Zimbabwe. The clients will hate it. Compliance will hate it. The consultants will hate it. Marketing will hate it. The size of the investment opportunity is tiny. It is not part of the benchmark. It is not even part of the Commonwealth. It's perfect.

Not that it is exactly risk free. Not "risky" in a tracking error, index relative, transient stock price quotation, quarterly reporting sense. The real risk comes in the form of a sleepy, quick to smile, want to get on with people apathy that pervades the population. The financial pages of Harare's Daily Mirror newspaper continue to publish the exchange rates for the deutschmark, French franc, Spanish peseta and Italian lira. Presumably it is someone's daily task to take one number and multiply it by another for the purpose of completing the next day's currency table. No one has noticed that the currencies no longer exist. This is not a good precedent for reform. Neither was the paper's headline which read – "Officials Grab Cell Phone Lines". First, there is the physical impossibility of the act; one could in theory grab a land line, but a wireless phone line? Secondly the problem is few people in Zimbabwe appear politically active, let alone angry. The editorial was not angry. And if no one is angry then what is the prospect of the Meikles Hotel occupancy exceeding its current 30%, except during the occasional English cricket team tour, which was controversial in England but locally ignored.

The most valuable company in the country as measured by the price of traded shares at the stock exchange is worth US\$150m at the official exchange rate, and US\$100m at the unofficial. That is less than one tenth of the quarterly dividend payment from the ExxonMobil Corporation. The price earnings ratio of the index constituent stocks is less than three. Most industrial concerns are valued at less than the replacement cost of their assets, not that anyone is replacing assets. And that's bullish. The ungeared Lafarge cement subsidiary has a market

capitalisation of U\$2.5m. There is some difficulty precisely assessing the size of plant capacity but bearing in mind that replacement cost for a cement plant is around US\$120m per ton, we don't need to be too accurate.

Zimbabwe is not a good advert for black capitalism. But it is not a good advert for white capitalism either. The occupation of white-owned farms looks racially motivated but note, it has been followed with the intimidation of black bankers as well. Zimbabwe can be described as a fascist state, in denial. Not only is not encouraging, but it is also not sustainable. Destroying the agricultural sector because it is white-controlled is stupid to the point of evil, when agriculture makes up 65% of the economy. It's the poor blacks that will be affected the most. The closest parallel may be that of Indonesia where the minority Chinese population control a large share of the economy. That is not necessarily a disproportionate share of the economy, as one likes to think they earned it. But the point is that the majority resent the rich minority, black or white, and the politicians feed on the distrust when their own policies have failed.

But unlike Indonesia, there was no boom to precede the bust. Zimbabwe has never been a tiger economy. This bust is political not economic. It is not predicated upon over-investment, over-borrowing or over-enthusiasm. But that means there is almost no bad debt in the economy. A visit to the publicly listed Barclays Zimbabwe revealed bad debts at 4% of the loan book. So, there is no recapitalisation needed here, no Argentinean default situation. One reason is that the dispossessed white farmers have repaid their mortgages and working capital loans in order to take title to their land. In most cases their farms have not been compulsorily purchased by the government, although the government has tried. Most farms have been occupied by mobs whose interest has been to loot, not produce. One farmer we spoke to had been given twenty-four hours to collect his belongings and arrange his affairs before occupation. The looters then looted, taking the 2,000 head of cattle to market in the nearby villages and apparently feasting on the cattle not sold. Yet the agricultural equipment was left untouched. There is no market for the kit with few productive outlets for its use domestically, and so it is left idle, waiting for its owner's return. In the meantime, the farm lies fallow, the equipment sits in storage, the economy is denied its exports and the currency spirals downward to reflect the country's new worth. When and if the regime changes some farmers will return, armed with their title certificates and reclaim their property – just as the Chinese have in Indonesia, and the West Germans in East Germany. Meikles Financial Services, a retail credit operation, claim bad debts of just 1% of receivables. Their loan book is lent to those that are staying in Zimbabwe. With debts this low, the economy could recover quickly when confidence returns. But what is to be done about the apathy?

In the early 1970s the black American poet and musician Gil Scott-Heron was an angry man. Unlike his fellow activists he was not just angry at the white establishment, he was also angry at the insincerity of his fellow black men: especially “those that hung out on street corners in Harlem with a ‘blacker-than-thou’ attitude” who felt that everyone-else owed them a living. This is the attitude of the political class in Zimbabwe. These are Ayn Rand's “looters”. In contrast to some of his fellow activists, Scott-Heron wanted his black peers to have integrity, be sincere, and be capitalists. Zimbabwe could do with a few Scott-Herons right now. Perhaps the lyrics to Scott-Heron's song “Brother” could be slipped into Robert Mugabe's suggestion box.

*“We deal in too many externals, brother  
Always afros, handshakes and dashikis  
Never can a man build a working structure for black capitalism,  
Always does the man rebound off a known.  
I think I know you would-be black revolutionaries too well*

*Standing on a box, on the corner, talking about blowing the white boy away, But  
that’s not where it is at yet, brother.*

*...You need to get your memory banks organised, brother Show  
that man you call an Uncle Tom just where he is wrong Show that  
woman you are a sincere black man  
All we need to do is see you shut up and be black Help  
that woman!  
Help that man!  
That’s what brothers are for, brother.”*