

Nomad Investment Partnership.

Interim Letter.

For the period ended June 30th, 2004.

Nomad's year to date performance is sufficiently close to the index (at the time of writing the differential is just 2%) to raise an eyebrow given the disdain with which we hold closet index managers. These are a sub-specie of professional fund managers that charge high active management fees whilst delivering index-like (i.e., non-active) performance. We can promise you that any resemblance Nomad may have to the closet index trackers is entirely coincidental. Our portfolio is nothing like the index. Indeed, it is not quite like anyone else's. And note, unlike the closet index trackers, at Nomad, no performance means no fees. That is the way it should be. (A notion to be slipped into your mutual fund manager's suggestion box!).

That said, the Nomad Investment Partnership Limited Partners interest and Nomad Investment Company Class A share gross results (i.e., net of management fees and costs, but before performance fees) for the last six months, trailing one and two years, as well as since inception (before and after performance fees) are tabled below on a compounded basis, together with comparable results for a leading global stock market index (also see appendix):

To June 30 th , 2004	<u>Nomad Investment Partnership*</u>	<u>MSCI World Index (net) US\$</u>
6 months	-0.97%	+3.52%
One year	+41.14	+24.00
Two years	+73.48	+21.06
Since inception (10/09/01)	+98.50	+14.37
Annualized since inception		
Before performance fees	+27.38%	+4.85
After performance fees	+23.14	

For those investors that joined part way through, or who despite our haranguing remain closet short-term oriented, the table below describes performance in increments (again, see appendix):

To June 30 th , 2004:	<u>Nomad Investment Partnership</u>	<u>MSCI World Index (net) US\$</u>
2004	-0.97%	+3.52%
2003	+79.64	+33.11
2002	+1.30	-19.89
2001 (inception 10/09/01)	+10.14	+3.61

Partnership Governance

In May, the balance of the funds waiting to be invested in Nomad were drawn down at a time when stock prices allowed us to lower the price to value ratio of the Partnership, and when insider buying, and share repurchase picked up at investee companies. The bulk of this

incremental capital was invested and leaves a cash balance of around 16% of assets. This too will be invested as and when prices allow. The Partnership has grown considerably in the last eighteen months to just over US\$100m and should now be considered closed. This is our natural state of affairs, and one that will be punctuated with open periods in response to price opportunities.

Job one, two and three for your manager is investment performance, not asset gathering. Few practice this approach. We work under the assumption that if performance is reasonable then the level of interest in what we are doing will increase and, if appropriate, the Partnership will grow in time. Common sense and simple maths dictate that it will be opportune if growth can be channeled to coincide with depressed prices, and not market tops. We must aim for this standard, even though it is contrary to common practice in the industry. Had we adopted the industry standard open house approach the Partnership would be approximately three times its current size, but the results worse, and the quality of Partners meaningfully impaired. It is important to us that we all understand the investment process (a reminder is contained in the appendix, in the form of an interview published in the Outstanding Investor Digest), try hard to keep a healthy indifference to results achieved (certainly no extrapolation of annual results please) and maintain a patient temperament. Investment dollars work best when they occupy a different psychic space to almost any other form of savings you may have.

The size of any future reopening will be proportionate to the opportunity set: a melt-down in large capitalization shares (please), a debt market swoon like the one recently experienced in the US, or an emerging market crisis as occurred a few years earlier, would allow the Partnership to be many times its current size and improve its potential returns. Today, the opportunities are mainly small and mid-capitalization companies, especially in Asia, and mainly turnarounds in nature (which bring with them reinvestment risk once the stock is sold). And so, for the time being the Partnership will retain its modest size. Over time this may change, but the timing of that change is outside our control. When we do reopen, we will write to those that have expressed an interest in investing more. This is likely to occur during periods of market stress and we will have to trust that indications made during rosier times turn into contrarian subscriptions. Very few organizations practice this common-sense approach because they understand how human nature works. They suspect (or know!) the average investor will be bearish at the bottom. There is no point taking that particular horse to water. At Nomad, we believe our Partners to be exceptional. Take the drawn down of the queue in May. Within forty-eight hours of indicating our preference, all those in the queue had consented to subscribe their full amount, at little notice, and with several offers for more if we wished. Wonderful. And thank you. You have quietly let us get on with the job of investing without the prodding and poking that is commonplace throughout the industry. In turn, we have felt trusted and free to invest in ways we think is appropriate to the benefit of all our results. We are aware that the industry's record in raising capital at market lows is not good. But we are happy to trust you to be contrarian at the next market swoon.

Current State of Partnership Investments

Growth in the Partnership and disparate performance of individual holdings means that the distribution of Partnership investments is a little more diffuse than would normally be the case. Ten holdings still make up almost half of the Partnership, but there is a tail of smaller investments from the early days, which were sizeable at one time, and now bring the total number of holdings to just over thirty. In effect, we are building a new portfolio (the ten large holdings) within the old portfolio (the tail). Around one third of Partnership assets are invested

in companies in South East Asia, one fifth each in the UK and the US and one-tenth in Europe. Approximately seventy percent of the Partnership is invested in common shares, ten percent in corporate bonds (distressed) and the balance held in cash on deposit. The estimated price to value ratio of the Partnership is 61c on the dollar, down slightly from the end of the year due to the new investments.

We have holdings ranging from almost 7% to 0.3% of assets. At the time of writing, Jardine Matheson/Strategic and Costco Wholesale are around 6.5% of Partnership assets each, Xerox 3.1%, but Union Cement around 1% and Velcro 0.6%. Why? A consequence of price discipline is that one cannot be certain of the size of the investment opportunity in advance. We simply cannot be sure how many people will be prepared to sell to us at our price: it may be 20 shares or 20% of the company. We hope for the latter but more recently have found it to be the former. An extreme example has been our attempt to purchase shares in Union Cement. This is the Philippines' largest cement company and has been priced in the market at around one quarter of the replacement cost of its assets. The assets are world scale and reasonably new, or at least were constructed during the Asian tiger boom of the early 1990s. The low valuation of the company in the markets had the desired effect in reducing capital investment (why spend discretionary resources on shiny new assets when the market valued them at 25% of cost?) and free cash flow was instead used to repay debt. Despite the turnaround in strategy, investors barely seemed to notice and the shares, which had already fallen from U\$0.30, bounced around between 1 and 2c a share. We started buying and in doing so raised the price over a six-month period from 1.5c to 2.5c and despite being almost the only buyer of shares we managed to purchase just U\$1m worth of stock. This is remarkably little when one considers that Union Cement is a large company with a market value of U\$200m and around U\$700m in gross assets. The shares simply would not trade, indeed the average holding period indicated by share turnover during much of this period implied a 40+ year outlook by investors, coincidentally comparable to the life of a cement plant. Of course, the more undervalued the company became the less the shares traded, as more holders understood the under-valuation. But still we plugged along in the hope that as the price rose, we would be able to secure some more stock. This was not to be. By the time Holcim, one of the world's largest cement companies, purchased a control block in the firm at an effective price for Union Cement of close to 10c (US) a share, five times our average purchase price, we had secured only a small holding. It is possible that we could have made Union Cement a meaningful ten percent investment in the Partnership. As it was, and despite our best efforts, we managed to achieve a miserable 1% investment. Charlie Munger is right when he says, "it is aggravating to just buy a bit".

Our thoughts on Portfolio Concentration

As the cash is invested, portfolio concentration will rise. In theory, if we could find fifty ideas at equal discounts to value, with equal probability (conviction) of value being realized, then they could all be equally weighted in the Partnership. We could all then look forward to a nice smooth rise in the value of our shares in Nomad, free from the swings a more concentrated portfolio might create. But life is not like that. In reality opportunities in which we are comfortable to deploy capital are rare, and the highest conviction ideas the rarest of them all. The issue then is how much to invest in each idea? Bill Miller, who has run the Legg Mason Value Trust so brilliantly for many years, suggests the use of a system devised in 1956 by J. L. Kelly. A simplified version of the Kelly criterion is that investors should bet a proportion of the portfolio equal to $2.1 \times p - 1.1$, where p is the probability of being right. The common-sense outcome of this equation is that if one is certain of being right, one should invest the

entire portfolio in that idea. Even if one is say, 75% certain of being right the correct weighting remains high at 47.5% $((2.1 \times 0.75) - 1.1)$. But does anyone do that? As far as we are aware, only the early Buffett Partnership portfolios had anywhere near this level of concentration, and then mainly in companies in which Buffett was a controlling shareholder. But is this not the right way to think? If you know you are right, why would you not bet a high proportion of the portfolio in that idea? The logical extension of this line of thought is that Nomad's portfolio concentration has at times been too low. And if it has been too low at Nomad, what has been going on at the large mutual fund complexes with many hundred stocks in a single country portfolio? Apply the Kelly criterion, and the average fund manager would appear to have almost no clue as to the likely success of any one idea. In our opinion, the massive over-diversification that is commonplace in the industry has more to do with marketing, making the clients feel comfortable, and the smoothing of results than it does with investment excellence. At Nomad we would rather results were more volatile year to year but maximized our rolling five-year outcome. If you do not share this view, think long and hard about your investment in Nomad.

One of the consequences of industry-wide over-diversification

Parents will understand when I say that when children are born, they seem to bring their own love with them. However, stocks are not like children. The more stocks you own the less you care about each one individually. Attention paid to corporate governance, capital allocation, incentive compensation, accounting, and strategy has to be diluted as the number of stocks rises. Alternatively, armies of analysts are drafted in, risking a decline into committee-based decision-making. When over-diversification becomes the industry norm then in aggregate investors risk failing to police bad corporate behavior. Would fund managers be so liberal with dysfunctional management if the holding was 20% of the portfolio rather than 0.2%? Of course not. Perhaps some of the scandals of the last few years would have been averted if fund managers had been more proprietorial about their holdings.

However, there are some glimmers of hope. We have been inclined to think of the largest shareholders in publicly listed companies as general partners. This works better with some fund management organizations than others, but the influence that a large properly oriented outside shareholder can have over corporate behavior should not be under-estimated. At Jardine Matheson, Brandes Investment Partners (the largest outside shareholder) proposed, and Marathon seconded, a motion to reorganize the firm. Although this proposal failed as management voted against via their shares in sister company Jardine Strategic, a watered-down version of the Brandes strategy has been pursued ever since and with wonderful results. At Kersaf, Allan Gray Limited and Marathon combined votes to propose an about-turn in company strategy. The strategy (all Allan Gray's work, not ours!) has proved to be excellent, and the share price of Kersaf has doubled in rand (and risen almost four-fold in dollars). At Hollinger International, Tweedy, Browne Company have professionally and selflessly pursued former Chairman Conrad Black to recover funds paid to him, and in the process have realized the private market value of the newspaper properties resulting in a doubling of the shares from Nomad's purchase. Our input has been limited to private correspondence with Lord Black, which is framed and may be viewed at Marathon's offices. Should you meet representatives from any of these fine investment-oriented fund management organizations buy them a drink. They have added greatly to your returns.

And lest you think Marathon has not been pulling its weight, at HCI, the owner of eTV, South

Africa's independent commercial TV station, Marathon is in the process of resisting in Court, an attempt by management to buy the firm against our wishes at what is demonstrably (and management agree) a massive discount to its real value. These actions are time consuming and expensive, but appropriate. To stand by and watch whilst we are having our wallet lifted makes little sense to us. Selling the shares and buying something else does no one any good either, even though this is common practice in the industry. As we wrote in the last letter:

“...the best defense is to own enough of the company to influence the outcome. In most cases in excess of 10% of the shares outstanding would suffice. Those that advocate market liquidity of their investments over other considerations might like to bear in mind an investor's inability to influence outcomes whilst owning a de minimus proportion of a company. Should Nomad continue to grow in size, we intend not to make this mistake”.

The likely evolution of Partnership Investments.

In the office we keep a list of companies assembled under the title “super high-quality thinkers”. This is not an easy club to join, and the list currently runs to fifteen businesses. Entry is reserved for the intellectually honest and economically rational, but that alone is not enough. There are many companies that do the right thing when their backs are against the wall, and this list excludes those temporarily attending church. The anointed few are there because they have chosen to out-think their competition and allocate capital over many years with discipline to reinforce their firm's competitive advantage. Good capital allocation takes many forms and does not necessarily require a firm to grow. The Partnership's successful investment in Stagecoach has been due to the firm's shrink strategy, not its growth, although that may come in time. At National Indemnity (an insurance subsidiary of Berkshire Hathaway), the firm's ability to write insurance only when pricing is good and stand back when pricing is poor, even if revenues decline by 80% and remain depressed for many years, is a wonderful example of capital discipline and good capital allocation. After all, why grow if returns are going to be poor? However, surprisingly few companies have the strength to just sit it out, or shrink, as the pressure to grow is often overwhelming. The clamor comes from within the company (reinforced by poorly constructed incentive compensation), Wall Street promoters and short-term shareholders. When faced with this barrage, the voice of the long-term shareholder often goes unheard. We ask companies with poor economics why they want to grow. And senior management, with their hands on our purse strings, look back at us incredulous at our line of questioning. It is just not that easy to resist the urge to grow, even if economic results look so so. The “super high-quality thinkers” are our best guess of those firms whose shareholders could abdicate their right to trade stock (allocate capital themselves) sure in the knowledge that their capital will be well allocated for years to come within the businesses. This list is a group of wonderful, honestly run compounding machines. We call this the “terminal portfolio”. This is where we want to go. The question is, why is this list not the same as the current Nomad portfolio?

This is not an easy question to answer. But let us return to the church analogy for a moment. When we think about companies, the over-riding analytical consideration is the quality of the business and quality of management's capital allocation decisions. The longer investors own shares the more their outcome is linked to these two metrics. What separates a corporate hero from a loon is an intellectually honest appraisal of business prospects and armed with that knowledge an appropriate allocation of discretionary resources. There are only two reasons companies behave well. Because they want to, and because they have to. Our preference is to invest in those that want to. If we can find enough of these heavenly opportunities, they will

in effect put us out of a job, and you should be pleased with this happy outcome (even we will be pleased, if a little bored). The problem of course is price. In paying up for excellent businesses today, investors are already paying for many years growth to come, in the hope that, as the saying goes, “*time is the friend of a good business*”.

We can all observe that stock prices, set in an auction market, are more volatile than business values. Several studies and casual observation reveal that individual prices oscillate widely around a central price year in year out, and for no apparent reason. Certainly, business values don't do this. Over time, this offers the prospect that any business, indeed all businesses, will be meaningfully mispriced. Even the mighty Berkshire Hathaway with its stalwart long-term shareholder base was demonstrably half priced in early 2000. And Marathon bought shares (unfortunately pre-Nomad inception). It is just a matter of time. Those that chase high prices today, leave less gunpowder for the future. In effect, they value future opportunities close to nil. So, opportunity cost is partly behind our decision as well. Today, we have made two investments in wonderful compounding machines, and only one of those is meaningfully represented in the portfolio (Costco Wholesale). What is the probability that say, over the next ten years, a good portion of these “super high-quality thinkers” will be priced at 50c? Our betting is that the odds are reasonable. Even though prices are generally high, the trick is to do the work today, so that we are ready.

And finally, the usual Housekeeping and a reminder on the Need for Patience

This final section may look familiar, as it is in part repeated from previous letters. However, this time we have included some thoughts on how we would like to be measured. The section may also be worth reiterating for those that have invested recently or are reaching the end of the letter for the first time (congratulations).

You can expect from us an annual and interim letter (this is our third interim letter) and Global Investment Reviews eight times a year in which we discuss our investment thoughts. In our opinion these documents, once digested, provide the information needed to form a judgement about what and how we are doing. From Nomad's administrator (Daiwa Securities Trust and Banking, +353 1603 9921 for your inquires) you can expect a monthly statement of your account and annual and interim financial statements. Do call them if you are not receiving all you should. Nomad's orientation is genuinely long-term, and more regular reports, daily, weekly, monthly, or otherwise, are likely to be of little value to you, and may even be counterproductive.

One of Nomad's key competitive advantages will be the aggregate patience of its Partners. We are genuinely investing for the long-term, in undervalued firms run by management teams who may be making decisions, the fruits of which may not be apparent for several years to come. Our preference is to be measured over a rolling five-year basis; consistent with time it takes for many large capital allocation decisions to bear fruit and the average period that we expect to own an investment. (Our framework for thinking about a typical purchase and expected returns was laid out in the December 2003 letter and is contained in the appendix to this letter.) If Nomad is to have a sustainable comparative advantage, this will come from the capital allocation skills of your manager and the patience of our Partners. In the latter we have started well, with no Partner turnover since we began and almost no enquires into performance despite the swings in general market prices. This is very unusual and a huge credit to our Partners and implies a similar long-term outlook. Only by looking further out than the short-term crowd can we expect to beat them. It is for this reason we named Nomad an Investment

Partnership and not a fund (and certainly not a hedge fund!). The relationship we seek is quite different.

We work hard at being as thorough and thoughtful as we can in making investment decisions. We do this conscientiously and have our own money on the line with you. It seems a considerable anomaly to us that the plethora of new investment boutiques and hedge funds that have emerged in the last few years have ostensibly the same investment process – short term, leveraged and news flow dominated. For our part we have no interest in such get-rich-quick schemes, and prefer to make money the old-fashioned way, through thoroughly researched and thoughtful stock picking, with a bias toward portfolio concentration and very low levels of turnover. This approach requires patience but suits our temperament and we believe will lead to satisfactory results in the long run.

As always, we thank you for your confidence and value your support.

Yours sincerely

Nicholas Sleep

Appendix 1: A Typical Purchase, Expected Returns, and Portfolio Management

This section was originally contained in the December 2003 letter to Partners.

An index has been included along with results at the beginning of this letter, not for the purpose of explicit benchmarking but in order to place performance in context. Nomad is an absolute return Partnership, which raises the question: what returns are we trying to achieve? At this point regular readers may feel that in trying to discuss prospective returns we are skiing off-piste. However, we would rather expectations were sensible rather than risk any mental extrapolation of historic results. To help illustrate the returns we aim to achieve, it may be helpful to explain what we are thinking when we buy a share.

Our aim is to make investments at prices we consider to be fifty cents on the dollar of what a typical firm is worth. Capital allocation by investee companies must be consistent with value creation and, if this is the case, we expect that the real value of the business (the 100 cents value) could grow at around 10% per annum. The effect over five years will be to compound U\$1 of value into U\$1.62, and companies that can build value like this are normally rewarded in the market with a fair valuation (i.e., are priced close to U\$1.62). This happy outcome would imply a return from purchase price (50 cents) of around 26% per annum. So, what happens when we are wrong? Our most common mistake is to misjudge capital allocation decisions by our companies: firms which articulate a share repurchase/debt repayment strategy and have incentives to reinforce that outcome, throw caution to the wind and make acquisitions instead. The Partnership's investment in Readers Digest falls into this category. Capital allocation mistakes such as these often prevent the compounding of value but to date have rarely resulted in a permanent decline in the share price to below our purchase price (50

cents). We have therefore tended to find that our mistakes atrophy (stay cheap) rather than collapse, although we can all name one collapse!

If over five years our mistakes are on aggregate flat, and our mistakes total half of Partnership assets, then this implies a compounded annual return of 13% for the portfolio as a whole². Not each year, and maybe not for several consecutive years, but over time this level of expectations appears reasonable to us. This model is daftly precise, a little too neat and the one thing we can almost guarantee is that returns will not be exactly 13%. It is important however that we all understand the investment process and time frames involved.

The prime determinants of outcome are price (sticking to 50 cents on the dollar) and capital allocation by management. The first is in our control, that is, it is in our control to be patient and wait for the right price. The second involves a subjective judgment about the quality of management, and an assessment about the sustainability of business returns in the long run. It is these factors that occupy almost all our time.

*Marathon Counsel: This is a hypothetical illustration only based on the assumptions set out above and is neither an indication or guarantee of the actual performance of the Partnership nor is it intended to form part of the investment objective of the Partnership.

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OID MAILBAG
"ANYBODY CAN OWN WHAT THEY LIKE.
THE CHALLENGE IS TO OWN WHAT YOU HATE."

In his first letter to Heritage Value Equity Fund shareholders since taking over management of the fund, David Dreman discusses his investment approach, his current outlook and some of his favorite equity selections. And then, in his most recent Global Investment Review, first-time contributor Nicholas Sleep touches on the concept of the equity yield curve and how to take advantage of it.

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OAKMARK FUNDS'
BILL NYGREN
"IN 2003, IT PAID TO AVOID EARNINGS AND DIVIDENDS.
BUT I WOULDN'T COUNT ON THAT CONTINUING."

From its inception on 11/1/96 through 12/31/03, Oakmark Select's shareholders have earned a compound return nearly three times that of the S&P 500 —22.2% vs. 8.1% —thanks to manager Bill Nygren (and co-manager Henry Berghoef since March 2000). Of course, we wouldn't ordinarily put too much weight on a seven-year record —

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BERKSHIRE AND WESCO ANNUAL MEETINGS
WARREN BUFFETT & CHARLIE MUNGER
"WHAT MAKES THE INVESTMENT GAME GREAT
IS YOU DON'T HAVE TO BE RIGHT ON EVERYTHING."

Anyone investing \$10,000 in Buffett Partnership, Ltd. at its inception in 1956 who reinvested the proceeds into Berkshire Hathaway at the partnership's termination in 1969 would today own shares worth over \$340 million. And that's after all taxes, fees and expenses. Just in case that's not sufficiently mind numbing for you, consider that before fees, but after taxes, the value would've been closer to \$600 million.

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SEMPER VIC PARTNERS' TOM RUSSO
"SOME CHEAP, HIGH-RETURN COMPANIES
SET TO CAPTURE LOTS OF INCREMENTAL GROWTH"

Under the direction of Gardner Russo & Gardner's Tom Russo, Semper Vic Partners has earned a compound annual return net of all fees and expenses for the 20 years ended December 31st of 18.5% versus 13.0% for the S&P 500. As we told you last time, its worst loss for any year was 2.1%. And during the the three years ending 12/31/02 — a period in which the S&P was down 14.6% per year — his clients were actually up over 4.6% per year after all fees and expenses.

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OID MAILBAG:**MARATHON — LONDON'S NICHOLAS SLEEP**
(cont'd from page 1)Global Investment Review
September 30, 2003**THERE'S A YIELD CURVE IN EQUITIES, TOO,
AND TODAY, IT'S PRETTY STEEP....****We agree with Bill Miller. We own what we hate....**

Nicholas Sleep: Regular readers (of our Global Investment Review) will be familiar with our contention that there are two areas of persistent mis-pricing: First are high quality, high return, high growth businesses where the stock price anticipates a decline in corporate performance that fails to materialize. Examples within current U.S. portfolios include **Moody's Corporation**, **Costra**, **International Speedway** and **Ethan Allen**.

Second are disasters (other people's that is) where business valuations anticipate dreadful performance for years to come. These companies are usually despised by investors and seen as controversial. And examples such as **Primedia**, **Xerox**, **Noriel** and **Solutia** populate our portfolio. **Bill Miller**, famed manager of the **Legg Mason Value Trust**, is fond of saying that "most fund managers own what they like to own. We own what we hate to own".

There is a strong element of this kind of thinking to the **Marathon** portfolios at the moment....

There's a yield curve in equities, too.

Sleep: Why do these anomalies persist? A critical role is played by the ever-shortening timeframes adopted by institutional investors. In consequence, longer-term opportunities are typically forgone. The problem with shorter holding periods is elucidated by the notion of the "equity yield curve". For this, we are indebted to **Murray Stahl** and **Steven Bregman** at **Horizon Asset Management** who brought the concept of an equity yield curve to life in [New York-based] **Crain's Interest Rate Observer** (in their December 22, 2000 [issue])....

A yield curve will be familiar to bond investors, but is rarely used to describe the stock market — the main conundrum being that equities have uncertain cash flows and no fixed redemption date. Equity, after all, is equity.

And the equity yield curve rises steeply after 18 months....

Sleep: But it is possible to plot the expected return for mandatory redeemable preferred shares where yield and duration are known and credit risk is minimal. In the original article, **Bregman** argues that the yield curve starts at Treasury rates of return and rises gently in line with bond yields for 18 months — i.e. it's "pretty efficient".

However, after 18 months the curve rises steeply to as high as 35 at two years (his study was performed at the end of 2000). We can't say we have seen too many 35% per annum propositions recently — at least not without taking on credit risk too. But **Bregman's** observation is important as it provides some theoretical underpinning for the structure of equity returns.

The question is, "Why?" And here's the answer....

Sleep: Why do mutual fund managers — who own shares on average for 11 months — invest at the Treasury end of the equity yield curve where returns are the lowest?

The answer probably lies in the error of their trying too hard to remove short-term share price volatility from portfolios (often referred to as, or confused with, "risk"). The effect is to prize the near term, more certain outcome. Furthermore, a liquid stock enables a swift exit just in case the investment decision proves wrong.

It is not surprising that **General Electric** is admired by investors for its low volatility of earnings growth and its huge and liquid market capitalization. Conversely, the dislike of earnings volatility is evidenced by the decline in the share price of **Essex-Lauder** after the firm announced that earnings would fall short of expectations because advertising and marketing were being raised. It's not so much the advertising spend (surely the sellers that day did

PORFOLIO REPORTS estimates the following were **Marathon Asset Mgmt.Ltd's** largest U.S. equity purchases during the 3 months ended 9/30/03:

1. SABRE HOLDINGS CORP CL A
2. SCHERING-PLOUGH CORP
3. SOLUTIA INC
4. WASTE MGMT INC
5. SUN MICROSYSTEMS INC
6. NEXTEL COMMUNICATIONS CL A
7. LUCOTTICA GROUP SPA ADR
8. IMS HEALTH INC
9. XEROX CORP
10. BERKSHIRE HATHAWAY CL B

not really think advertising and marketing destroys value?) — rather it is the earnings disappointment that the ad spend creates which investors object to.

FOR EXAMPLE, TAKE SCHERING-PLOUGH — PLEASE.
WHEN IT RAINS, IT POURS. MURPHY WAS AN OPTIMIST.

S&P has a pretty steep yield curve. And here's why....

Sleep: What is the shape of the "equity yield curve" today? There are several mandatory redeemable preference shares that are priced to yield 8-15% to maturity in four to eight years. But these, unsurprisingly, are fairly illiquid. However there are several U.S. businesses that imply that the shape of the curve is still pretty steep. Take for example **Marathon's** recent investment in **Schering-Plough**. (Ed. note: All the following figures are in U.S. dollars.)

During the late 1990s **Schering-Plough**, along with **Pfizer**, was many portfolio managers' "big pharma" growth stock of choice, and in 1999 the firm's valuation peaked at \$88 billion (\$60 per share) to discount growth of around 15% per annum until 2008. The reason for this stellar valuation was that investors observed and extrapolated past successes: first, the growth in two company-developed proprietary drugs, **Intron A** — an "alpha interferon" for treatment for Hepatitis B, C and cancer; and **Claritin** — a non-sedating antihistamine with widespread applications.

(continued on next page)

OID MAILBAG:
MARATHON — LONDON'S NICHOLAS SLEEP
 (cont'd from preceding page)

It used to be clear sailing for Schering-Plough....

Sleep: The second reason was the extension of the economic life of Claritin through the company's innovative use of line extensions that focused on new delivery routes (syringes, tablets, lozenges, inhalers etc.) marketed directly at the consumer: Schering-Plough thinks of itself as the preeminent drug stock in this regard.

The effect was that its revenues doubled between 1994 and 1999 (with low product risk), its operating margins rose by 400 basis points and its operating cash flow nearly tripled. As capital spending remained almost unchanged, the company's free cash flow rose almost four fold.

SGP did nothing wrong. It just couldn't prove it....

Sleep: It was this latter metric that appears to have caused the company's downfall, as in May 2002 the FDA closed down the firm's Claritin factories for what it termed "compliance failures". In particular, the firm was unable to provide documentary evidence for each stage of the manufacturing process — although there was no suggestion that the quality of the product was faulty.

The firm has been fined \$500 million and entered into a consent decree [which expires in] 2005. This came at a time when Claritin was finally coming off patent and prevented production of a Clarinex line extension.

When it rains, it pours....

Sleep: The generics have had a field day. During the second quarter of 2003 alone, revenues declined from \$3.2 billion to \$2.7 billion and cash flow halved. The timing could not have been worse. Next came an investigation by several states into the marketing and pricing of products. The investigation's turned criminal (the first criminal case in the sector) and may result in a fine of between \$100 and \$900 million according to various Wall Street estimates.

In the autumn of 2002, the SEC began an investigation into Schering-Plough's communications with investors following a meeting with a large mutual fund manager which presumably fell outside of Reg. FD. All of this has taken the share price down from \$60 to \$15.

HOW FAR OUT CAN ANALYSTS SEE?
 LESS THAN THREE YEARS, APPARENTLY.

Under Fred Hassan, the turnaround begins....

Sleep: Richard Kogan, CEO and chairman since '98, resigned.... The successor's turned out to be Fred Hassan — formerly of American Home Products and then Pharmacia and Pfizer. Hassan's bias is to effect an operating turnaround with limited cost cutting rather than slash burn and sell.

Hope for a revenue-based turnaround comes in the form of Zetia which, when used in combination with statins such as Merck's Zocor, reduces cholesterol at a lower dosage than Zocor alone. A 50/50 joint venture's been established. But as Zocor does not come off patent until '06, Merck are in little hurry to cannibalize their own revenues just yet.

A one pill Zetia/Zocor combination is in the phase III clinical trials necessary to license a one-pill product and

thus allow one insurance claim (and co-pay) as opposed to the current two.

It seems that 23 of 29 analysts can't look out three years.

Sleep: Unlike most pipeline drugs, the efficacy and demand for the Zetia/Zocor combination is already known. It's tried and tested and used today by those who can afford the cost of the extra co-pay pill. And the project would appear lower risk than the normal, jam-tomorrow pipeline drug. According to various Wall Street estimates, Schering-Plough's share of Zocor/Zetia earnings is expected to be about \$800 million post tax in '07 — roughly double the current profits for all of Schering-Plough.

But despite acknowledging the probability of Zocor/Zetia earnings in '07, Wall Street isn't prepared to wait. Of the 29 analysts covering the firm, only six — none of whom work for the main stockbrokerage firms — think it's a buy. It appears that with a reasonable degree of certainty, attributable operating profits (note Zetia/Zocor is a joint venture) will be in the neighborhood of \$2 billion in '07.

Schering's current price discounts no growth in cash flow.

Sleep: Whenever we value any business, we subtract maintenance capex, taxes and normalized interest costs and make assumptions for growth and its longevity and add back non-core assets and the value of fixed assets plus cash, net of liabilities. Assuming modest growth of 5-7% in '07 this would imply a value for the business of around \$38 billion (\$28 billion growth stock plus \$10 billion in residual assets).

[Editor's note: Dividing by the 1.45 billion shares that Value Line expects Schering-Plough to have outstanding in 2007, that would be equivalent to about \$26 per share....]

Sleep: As the market tends to discount near-term events in advance, this valuation may be achieved in '06 — which would imply an annual return of 20% per annum from Marathon's purchase price. In other words, the equity yield curve looks pretty steep.

Of course, Zetia/Zocor may not be a success, its launch may be delayed, it may cost more than anticipated to market or Pfizer may trump it with a better product. Despite this, as the current valuation of Schering-Plough discounts no growth in cash flow for the foreseeable future, the downside appears modest.

We didn't think we'd have the opportunity to own SGP.

Sleep: To conclude, despite our recent performance, we remain optimistic for future relative returns. The reason is that structural price anomalies persist in keeping with the theoretical insight provided by the equity yield curve concept described above. Indeed, as the average holding period of shares has declined, it is our opinion that long-term mispricing has become more widespread as investors allow their actions to be driven by false stimuli. Investment opportunities may not be in the same sectors as in 1999 and 2000, but the prospective returns, (i.e. the steepness of the "equity yield curve"), remain attractive.

Five years ago we would have thought it unlikely that we would own shares in Schering-Plough, but events have conspired to make the shares an attractive investment.

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