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## Nomad Investment Partnership

### Interim Letter

For the period ended June 30<sup>th</sup>, 2007

To June 30th, 2007	<u>Nomad Investment Partnership</u>	<u>MSCI World Index (net) US\$</u>
Trailing:		
One year*	+29.5%	+23.6%
Two years	+42.6	+33.8
Three years	+80.1	+59.0
Four years	+154.0	+97.2
Five years	+212.4	+92.5
Since inception (Sept 10 <sup>th</sup> 2001)	+258.1	+81.9
Annualized since inception		
Before performance fees	+27.2%	+11.9%
After performance fees	+23.2	

The figures above are unaudited and presented on a cumulative basis. 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.

To June 30 <sup>th</sup> 2007:	<u>Nomad Investment Partnership</u>	<u>MSCI World Index (net) US\$</u>
Calendar Year Results:		
2007 (year to date)	+17.6%	+ 9.2%
2006	+13.6	+20.1
2005	+9.2	+9.5
2004	+22.1	+14.7
2003	+79.6	+33.1
2002	+1.3	-19.9
2001 (inception Sept 10 <sup>th</sup> 2001)	+10.1	+3.6

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Since the Partnership opened, and almost simultaneously closed, to new subscriptions (technically) at midnight on September 28<sup>th</sup> 2006 (blink and you missed it), the gross net asset value has risen over twenty-eight percent and means that a dollar invested in Nomad at inception would now be worth around \$3.58. We usually quote performance after the cost of running the Partnership such as custodian, director, auditor and administrator fees,

but before fees earned by the investment advisor. We quote results this way as many Partners\*\* have different subscription dates and, due to the six percent performance hurdle used to calculate performance fees, will have various net-of-performance-fee experiences. The results above are also before our cost-reimbursement management fee, which does not make much of a dent to the net- of-all-fees result.

The circa forty percent annualized gain for Nomad since September last year is quite normal in the sense of being within an expected distribution of short-term results, but even so it is ahead of our averaged-out, multiyear return, which has been in the order of half as great. As ever, a stoic indifference to these short-term steps, both up and down, is the right way to think, and Zak and I would encourage you to mentally reallocate recent excess to leaner periods. Make that, future leaner periods! As Mrs. Zakaria and Mrs. Sleep remind us, we are no cleverer today than we were last year, although our results recently have been far superior.

The lag that often exists between investment decision and eventual reward is a problem for long-term investors, as the brain is wired to learn from immediate feedback. The biological presumption (and, as mentioned in the last Nomad letter, the academic presumption too) is that cause and effect sit chronologically on top of each other – after all, you would want to know that the plant you have just eaten is poisonous now (so you can stop eating it) rather than in a week's time, when it would be too late. Stock traders benefit from the same immediate feedback, but not so long-term investors who run the investment equivalent risk of continuing to eat the hemlock. The real world is messy, and moves in a messy sort of way, and means that long term investors probably have to work harder at intellectual honesty so as not to mis-analyse cause and effect. We all fool ourselves to some extent and so this hair-shirted attitude is hard work. Perhaps it is the biggest investment challenge of them all!

### An Introduction to the Santa Fe Institute

One way not to fool oneself is to spend time with one's intellectual superiors and it is in this spirit that Zak and I became members of the Santa Fe Institute (SFI) some years ago. The SFI was founded by Murray Gell-Mann and seven, principally Los Alamos, scientists who were frustrated with the gaps between contemporary academic disciplines. To this group, traditional academia discouraged broader interests (physicists study physics, not biology) and this left many problems unsolved because they fell across disciplines. Their solution was an interdisciplinary, collaborative approach to problem solving.

Witness the SFI's description of the economy. Traditional economists argue that people are rational beings who seek, what economists call, utility maximization, that is, the maximum output for any one input. This old guard are hostile to assertions of non-rational behavior, perhaps because the idea that we are all rational is just so elegant. Scientist and External SFI Professor W. Brian Arthur argues that this static, equilibrium-based model of the world does not sit easily with the biologist's view that individuals act in self-interest, make mistakes, learn and evolve. Or the psychologists' view of the world that there are systematic biases to individual decisions – that is, we have these little wobbles in our decision-making processes. Brian Arthur's approach is to borrow what he needs from all the academic disciplines to describe a reality that is a little wayward compared to that the traditional economists would expect. As Gell- Mann puts it, the real world "is not just a look up table". Instead, Arthur describes the economy as a Complex Adaptive System that evolves as agents (people) learn.

The SFI describes itself as studying the Science of Complexity and, in our opinion, that seems like a better model to explain reality. After all, how can economics not be behavioral – who

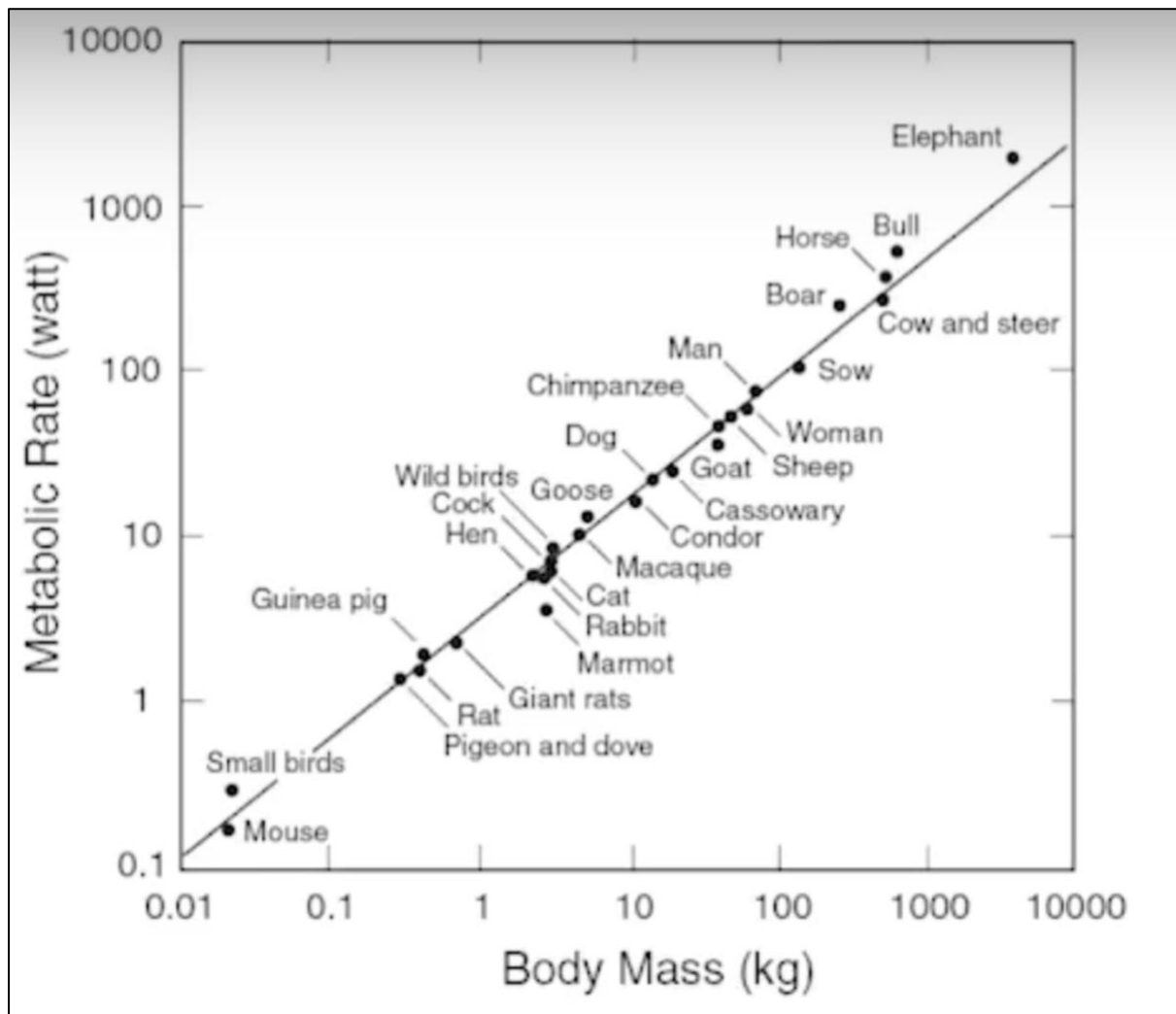
is making the decisions after all? In our opinion, Brian Arthur's Complex Adaptive System and the behavioral finance work pursued by the likes of Professor Richard Zeckhauser at Harvard are the new economics in waiting. As the saying goes, one scientist would rather borrow another's toothbrush than his ideas and it is with this attitude that, and with apologies to MBA students, the new economics of Complexity Science is unlikely to be taught to any great degree in academia until the utility maximizing old guard, that dominate academic institutions, die off.

After a recent speech Gell-Mann was asked, "So, how do you have creative thinking?" His answer was: 1. Start thinking about something, gather data to the point of saturation, recognise anomalies and recognise that you are now stuck; 2. Retreat and simmer, mull it over and a period of incubation ensues with the unconscious mind deployed; 3. Whilst doing something else a solution to the problem surfaces (Archimedes' eureka revelation); 4. Go and verify the new solution. To Gell-Mann, taking time is important in creative thinking. The landscape architect Charles Jencks, who designed the "Garden of Cosmic Speculation", echoes this sentiment. Jencks's garden is an attempt to put the new Science of Complexity into garden design and symbolism. (If in Dumfries, Scotland in June we thoroughly recommend a visit, and take us with you! – but note it is only open to the public for one day a year). To Jencks "understanding requires a certain slowing of time. Why else enter a garden?" There is a lot to be said for gentle contemplation. And of course, a long investment holding period allows one time between decisions to "retreat and simmer" a little.

### An Introduction to Scaling Laws

It is perhaps only in a supportive, interdisciplinary institute such as the SFI that Geoff West could embark on a study of scaling laws. Two questions concerned West: why do small animals live for less time than bigger animals, and why do humans live for around one hundred years rather than say, one thousand years, or one year? The simplest of scaling laws concerns body-mass and skeletal strength. As an organism increases in size its body-mass grows with volume (to the cubed) whilst the shear strength of the skeleton only increases with the width of the bones (to the squared, or a power law of  $3/2$ ). Without a bigger bone structure, mass soon overwhelms strength, and the organism collapses under its own weight! (A few companies we know have followed a similar pattern). Metabolic rates (as measured by oxygen used) also rise with body mass, but at a declining rate (a power law of  $3/4$ ). This implies there is an economy of scale to mass in animals, further evidence of which might be that heartbeats per minute also decline with mass. This is Kleiber's Law and it states that literally a kilo of mouse costs more energy to live than a kilo of say, whale. West put the two power laws together and realized that if longevity increases with mass, and the heart rate decreases with mass, then it follows that all life shares a common number of heartbeats (indeed, around one billion). A mouse uses up its billion heartbeats in about four years (at a rate of five hundred beats per minute) whilst an elephant uses up its billion heartbeats in seventy years (at a rate of twenty-five beats per minute). It seems that evolution has not changed this basic constraint: a billion heartbeats it is, careful how you use them!

Chart1: A billion heartbeats it is: careful how you use them!



Source: Santa Fe Institute

But even so, why does the mouse heart beat so quickly? In all animals the aggregate cross-sectional area of the blood vessels increases with distance from the heart. The purpose of this is to overcome the viscous drag created by blood coming into contact with vessel walls. Smaller animals do not have the space in their body to allow for much cross sectional widening, and so the mouse heart works harder to overcome the blood's resistance to flow. In larger animals the distance between the heart and the body's cells is much greater and so the cross-sectional area can be increased much more.

In other words, there is a very basic function to longevity with skeletal strength allowing for size, size allowing for circulatory efficiency, and efficiency allowing for longevity. The answer to West's question is that man lives for around a hundred years as this is all his heart can cope with, given body-mass and skeletal strength.

## What can Investors learn from Scaling Laws?

This might be the right way to think about scaling in organisms, but does it tell us anything about companies, and especially firms as they grow? The question that needs to be answered is: why is it predictable that a business will grow from a mouse to an elephant? This is a little like asking the meaning of life, and we will try hard not to give an answer as intractable as Douglas Adams' suggestion in *The Hitch-Hiker's Guide to the Galaxy* (where the answer to life, the universe and everything was "42"! ). Several tenets are important. A business ought to be able to self-fund its own growth, and if the opportunity set is large, then the return on capital needs to be suitably high. Second, barriers to entry should increase with size; that way a company's moat is widened as the firm grows. To do this, the basic building block of the business, its skeletal structure, is probably best kept very simple. In short, we want a skeletal structure that can support growth from mouse to elephant without too much skeletal re-engineering.

Let's consider traditional high street retailing. Goods are sent from the supplier to the retailers' central warehouse, where they are stored until demanded by the shops. Goods are then sent to the high street stores. These are expensive pieces of real estate and have high operating costs. Price aside for a moment, the quality of service the consumer perceives is largely a function of staff levels, staff helpfulness, product range, shop furnishings and so on. So, there are lots of constantly variable elements to service quality at the most expensive end of the distribution system. It seems to us that the skeletal structure is highly complex, and many things can go wrong.

Contrast this to the internet model. Goods are sent from the supplier to a central warehouse, but often only after the order has been taken. The goods are then sent direct to the customer with the expensive high street real estate missed out. The quality of service perceived by the customer is the speed of delivery, the feel of the web site, functionality of the web site (such as recommendations), breadth of product range and so on and these factors are inherently more controllable. They are fixed in terms of expense and also customer experience (a web site viewed in New York looks the same as the same website viewed in London or Hong Kong). So, whilst quality is inherently patchy at most high street retailers, it is fixed at Amazon. This is important as it is complexity that is one of the main reasons firms fail as they try to grow.

It seems to us that the basic building block of internet retailing, its skeletal structure, is far more robust, scalable and cheaper than the high street equivalent. In other words, its power law is very high, and implies that businesses with the simplicity of operation as say, Amazon.com, have a shot at being far bigger, quicker and more profitable than their high street equivalents. Nomad has an investment in Amazon for more reasons than the firm's simplicity of operations. But when this basic building block is combined with the scale efficiencies shared model (which increases the moat as the firm grows), customer centric orientation of the firm's founder, as well as his healthy disdain for Wall Street, this combination makes us think that we may have a mouse that can turn into an elephant. To those who argue Amazon is large already we ask two questions: what do you think e-commerce will be as a proportion of US retailing in ten-years' time, and what do you think it was last year? Write both numbers down and turn to the end of this letter\*\*\* for the answer to the second question.

After the doubling in the share price and the weighty resultant position in the Partnership it would be easy for Zak and me to claim victory, high five, and sell our shares in Amazon. However, the high weighting makes sense given our understanding of the destination of the businesses and the probability of reaching that destination. In previous Nomad letters we have argued that the biggest error an investor can make is the sale of a Wal-Mart or a Microsoft in the early stages of the company's growth. Mathematically this error is far greater than the equivalent sum invested in a firm that goes bankrupt. The industry tends to gloss over this fact, perhaps because opportunity costs go unrecorded in performance records. For example, our greatest error was the sale of Stagecoach (which has risen ever since sold), not the purchase of Conesco! We wonder, would selling Amazon today would be the equivalent mistake of selling Wal-Mart in 1980 (a similar time period after both companies' IPOs)?

### Short-term result volatility and stock weighting

It is commonplace for overall portfolio construction to be as a result of stock weightings built up from one to two to three percent of a portfolio and so on up to a target holding. This means that weightings are anchored at a small number with only outliers reaching double digits. There is another way to construct a portfolio, which is to invert and start at a hundred percent weighting and work down! If fund managers did this, I am sure they would end up with completely different portfolios. Now we are not advocating all the fund in Amazon (well, not just yet at least), but in allowing past habits to anchor portfolio construction we have probably made the mistake of a starting holding that was almost certainly too low. Be that as it may, one effect of having one sixth of the Partnership invested in a volatile stock, such as Amazon, is that our results will also be more variable over the short term. Please bear that in mind in future performance. The volatility does not bother Zak and me one jot.

Our results since inception have been large, out-sized multi-year gains during periods of market distress (2001 to 2004) and reasonable, index matching/bettering multi-year results during stock market boom periods (2005 to 2007). This follows the predicted path outlined in the June 2002 Nomad letter when we quoted a Buffett Partnership letter from 1960:

*"I have pointed out that any superior record which we might accomplish should not be expected to be evidenced by a relatively constant advantage in performance compared to the Average. Rather it is likely that if such an advantage is achieved, it will be through better-than-average performance in stable or declining markets and average, or perhaps even poorer-than-average performance in rising markets."*

And we certainly do not have a relatively constant advantage compared to the index!

### The Deep Reality of the Markets

It was recently reported that oil had been found, not in the far flung reaches of the globe, but under the headquarters of the Exxon Mobil Corporation in Irving, Texas, and not by Exxon! Sometimes, what you are looking for is right in front of you. If Exxon can make this mistake, we all can. Investors are often guilty of chasing the new-new thing far from home sometimes in the name of diversification, or higher returns, or both. To our way of thinking such activity often has more to do with marketing than it does with underlying investment reality. Selling

the new thing in order to buy the new-new thing is a common human habit (as a society we trade houses, cars, wives rather than try to fix roofs, gearboxes, marriages) and it almost always raises the question, why are people dissatisfied with what they have? In the spirit of trying not to make Exxon's mistake, we suspect that Nomad portfolio turnover will be particularly low going forward: we are quite happy with what we are currently sitting on. One reason for this is that the fund is over-whelmingly (over eighty-five percent) invested in firms run by their founders or first-generation management. Just as interesting is that Zak and I did not plan for this! We have ended up with a portfolio of owner-managed businesses as a by-product of our assessment of the quality of the people involved. In other words, these managers earned their way into the portfolio. We feel slightly foolish for not recognizing this trait in advance, but, of course, we *would* have a bias toward founder-managed businesses (duh!).

By the standards of the industry, we do not own very many shares (ten stocks account for over eighty percent of the Partnership) and we own them for long periods. If the existing portfolio is to be successful then our results will come from the mismatch between the orientation of the founders and the mark to market mentality of the quarterly holding period investors that set the price of the companies on the stock market. This principal (founder) agent (trading oriented fund manager) conflict is the deep reality of the markets and probably the dominant characteristic of our careers. I also think we understand it far better than our peers.

#### The Terms of Future Capital Raising.

Before there is any sucking of teeth, we do not have any plans to raise capital. Really. But we do wish to set out our stall now for the next investment crisis, and that crisis could come quickly. As we have always said in the past, capital should only be raised in response to investment opportunity sets (to be slipped into the suggestion box of marketing-oriented fund management operations). Rightly or wrongly (and there is a perfectly rational case that we are wrong) we have an over-riding bias to keep our operation small. However, we are also conscious that a repeat of the Asian crisis or the junk bond crisis would allow us to invest multiples the current size of Nomad with better results for all concerned. So, for illustration, let's say Nomad is a US\$1bn Partnership and there is a new crisis and we raise a further US\$1bn with the result that after the crisis has abated, Nomad is say, US\$4bn in value. US\$4bn is not a small amount of capital, especially in a concentrated portfolio. The rational thing may be to return the crisis capital to investors and right size back to the original capital. So, our suggestion is that a future capital raising would, in effect, be a rights issue of redeemable shares, which would give Zak and me the option of shrinking. We are flagging this now, and we welcome your thoughts on the subject. Speak up or forever hold your peace!

#### Housekeeping

We write these letters and hope to provide all the useful-to-know information to allow you to draw meaningful conclusions about our ability to manage your money. This is the information we would want if the tables were turned, and you managed our money. In our opinion, more regular reporting of a long-term fund is meaningless at best, and counter-productive at worst. It is only in the Alice-in-Wonderland world of the modern investment profession that incessant gathering of puerile data points can pass for best practice reporting. There's that principal agent conflict again! It is to the very great credit of our Partners who, almost to a man and regardless of demands made of other managers, abide by this simple rule. Thank you.

We have excluded a copy of the portfolio from the appendix, and instead it will follow under separate post, or email. This is a precaution against our letter being circulated beyond our investor base. Included in the appendix you will find a copy of our response to a Partner's request that we consider divesting of businesses with operations in the Sudan. The letter makes our position on the issue clear, and there is little point in repeating the words here. Sudan is not so much the point, as previous requests have been made relating to arms, tobacco, alcohol, or certain South African and Irish businesses. The wider issue is the governance of our Partnership, and whether a minority group should be allowed to assert an agenda over the majority. For better or worse, the Partnership structure means that Nomad is a cooperative (of sorts), albeit with a mandate for the long-term growth of capital. In our analysis of investments, we may well take into account the factors raised by those that seek a ban on certain companies but, so all is clear, we may still buy the shares. Of course, how investors then allocate any profits they may have from their investment in Nomad is entirely up to them.

It is nine months now since Nomad was handed to the new company and operations appear to be bedding down well. We are gently reviewing the old, inherited relationships and contracts and there may be some changes to subcontracted parties to come. It is interesting how attitudes change now that Nomad is no longer part of a large organization. These changes are very often for the better, but occasionally those firms with a cookie-cutter business model struggle with our more bespoke approach and they need to be swapped out. The cost-reimbursement management fee is settling down in the low 30 basis points. This is at the high end of our (back of the envelope, not done this before) expectations, and we expect it now to stay flat in dollars and decline as a proportion of the Partnership in time.

Performance has been strong since we raised new capital (we weren't making it up!), but Partners should not extrapolate recent trends in their expectations of us. That is simply a recipe for everyone to get upset. That said, the portfolio is young and fresh and is populated with businesses that are healthily out of step with Wall Street or City expectations. Instead, our founders are planning for growth in five-years' time. This "founder's portfolio" will serve us well in the absence of investment crises.

In my first week as a trainee investment analyst (having just abandoned a landscape architecture apprenticeship) one of the founders and fund managers of my new employer sat me down for some homely advice. In his broad Scottish accent he said, "well, young Nick", there was then a long pause and he began to smile "this job is the best fun you can have with your clothes on". He was right. Zak and I love running Nomad, and to do so under our own steam is special to us. Thank you.

We prize your patience, support and confidence in us, and we are working hard preparing the ground for further increases in the Nomad share price.

Yours sincerely,

Nicholas Sleep

\* Sleep, Zakaria and Company was appointed as investment advisor to the Nomad Investment Partnership with effect from September 12<sup>th</sup> 2006, replacing Marathon Asset Management who had been investment advisor to the Partnership since inception. Prior to September, Nicholas Sleep and Qais Zakaria were responsible for the investment management of Nomad whilst employed by Marathon Asset Management. Partners should note that the very nature of the transition from Marathon to Sleep, Zakaria and Company means that Zak and I are not operating with the back office infrastructure we used to receive.

\*\* In this letter we use the term "Partners" as a generic term referring to all Nomad investors, whether shareholders in the feeder fund (the Nomad Investment Company) 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 Sleep, Zakaria and Company, Ltd.

\*\*\* The US Census Bureau estimates that e-commerce sales grew from 2.7% to 3.1% of all retail sales in the United States during the quarters of 2006. The source document can be found at [www.census.gov/mrts/www/data/html/07Q1table1.html](http://www.census.gov/mrts/www/data/html/07Q1table1.html).

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