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Nomad Investment Partnership

Annual Letter For the period ended December 31st, 2006

| To December 31st, 2006 | <u>Nomad Investment Partnership</u> | <u>MSCI World Index (net) US\$</u> |
|--|---|--|
| One year* | +13.6% | +20.1% |
| Two years | +24.1 | +31.5 |
| Three years | +51.3 | +51.5 |
| Four years | +171.8 | +103.0 |
| Five years | +175.3 | +63.8 |
| Since inception (Sept 10 th 2001) | +203.2 | +70.2 |
| Annualized since inception | | |
| Before performance fees | +23.2% | +10.6% |
| After performance fees | +20.4 | |

The figures above are unaudited and presented on a cumulative basis (after management fees, the cost of running the Partnership including custodian, auditor and administrator fees, but 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.

| To December 31st, 2006: | <u>Nomad Investment Partnership</u> | <u>MSCI World Index (net) US\$</u> |
|---|---|--|
| 2006 | +13.6% | +20.1% |
| 2005 | +9.2 | +9.5 |
| 2004 | +22.0 | +15.2 |
| 2003 | +79.6 | +34.0 |
| 2002 | +1.3 | -19.3 |
| 2001 (inception Sept 10 th 2001) | +10.1 | +3.9 |

The Benchmark

2006 was quite a year for Zak and me in all respects bar one: Nomad was successfully separated from its alma mater, the new refundable performance fee and cost reimbursement management fees were (perhaps unsurprisingly!) accepted by Partners**, and we seem, broadly, to have all the systems we need to operate an effective investment function

established in Galactic headquarters at Burnsall Street. Even so performance, certainly relative to one alternative presented by the index described above, was only so-so. Alright in absolute terms, and reasonable perhaps as we compound our way along but, I'm afraid, in 2006 you would have done better buying an index fund (if only we knew which to buy in advance?)

So, there is no confusion: the index is not our benchmark. Zak and I spend no time at all thinking about the index (indeed we were unaware of the index return until I set about writing this letter) and its inclusion at the top of this letter reflects our genesis in an index-relative investment firm more than our orientation. If we started Nomad again today, I'm not sure we would present results this way but, be that as it may, we will leave the index at the top of this letter for now, as for some Partners it may be helpful in placing our results in context.

Zak and I have witnessed many investors make terrible investment decisions from thinking via the index. The most common mistake is to view the index (indeed any index?) as a risk-free "home". That this disposition still exists after the irrational index bubbles that preceded the Asian crisis and technology collapse may be testament to the strength of the marketing skills of the financial establishment. Once the index is seen as risk free the mistakes that follow cascade and include: requirement to have an opinion on everything inside the index regardless of one's circle of competence, an unwillingness to invest in other better opportunities, and over diversification. These three mistakes destroy a lot of capital. We came across one country manager's report claiming that although his country had done poorly it had proved valuable as a "portfolio diversifier" in a global fund: Many a furrowed brow these last few weeks figuring out what that means! Even so, index relative funds are the industry norm because they sell. And they sell because the client does not trust their manager with the keys to the Ferrari. It is a ghastly Faustian pact.

We are walking down the road less traveled when we argue that the index is not risk free, it is one, of many, opportunity sets. This year that opportunity set beat us. It may do so again next year too. And the year after that. We should all be prepared for that possibility and stoic at its occurrence. A rational mind understands that it is the destination that is important, and if we have some skill in picking stocks (please, no answers on a post card!) then, whilst annual returns may bounce around, our destination will be some way ahead of the index. Zak and I are not envious of index returns and we encourage you not to be either. We see our goal as far more personal than that. Our goal is a track record to be proud of, we wish to accomplish something meaningful, and to do that we aim to earn returns, over time, on par with those investors we greatly admire (Ruane, Tweedy, Klarman, Whitman, Hawkins, Miller, Schloss, Berkowitz). In no way do we guarantee returns, but if we can approach their results then, over time, we will beat the index too.

The fifth anniversary of the inception of Nomad occurred in September 2006 and represents a suitable milestone from which to assess the journey so far. A few weeks after the anniversary the share price rose through U\$3000 (before performance fees) and this means that it took a little over five years to triple the original dollar invested. (We usually quote performance before performance fees. We do this as many Partners have different subscription dates and, due to the 6% performance hurdle used to calculate fees, will therefore have various net-of-performance-fee experiences. The net-of-performance-fee share price was U\$2680 at year-end). 23% per cent compound per annum for five years in a 5% interest rate world is perhaps ahead of what we might consider normal performance and, as we have said in the past, reflects the opportunity set in the early days.

There are two reasons for our relative performance this year – the first is that our companies, by and large, are reinvesting heavily in their businesses at a time when the market, taking its cue from the private equity buyers, have rewarded firms with high levels of current free cash flow. Second, it is also possible that the one-off workload associated with the transition of Nomad to SZ and Co, a very high proportion of which was bespoke work (notably the refundable performance fee), diverted attention from the day job. Zak and I consider non-investment distractions to be the single biggest risk to our operation and we are on to it. Amanda has the budget she needs to allow us to devolve duties but this process is new to us and we are learning as we go.

In 1948, Freddie Settrington (he rarely used the title Lord March) hosted his first motor racing event on the perimeter road of the airfield that lay in one corner of his Sussex estate. At first it was a modest affair, as the foreword to the first race card makes clear:

“We’ll be quite frank with you from the start. This race meeting is an experiment. We cannot, on this occasion, offer you a seat in a grandstand – or even a seat at all. You’ll be able to obtain some refreshments, and the loudspeaker people will do their best to make certain you hear the numbers of non-starters and of the winners.

“We think you will see some quite good racing and share our surprise if the programme keeps up to time. But if all the refinements of a fully developed sporting arena are missing take our word for it, they will appear eventually- particularly if we have any success with the show today.

“Meanwhile, months of negotiations have been necessary, just to make to-day’s meeting possible. Government Departments have been involved – and you know what that means – but we’ve stuck manfully to the job, and here we are. To do justice to those with whom we have been called upon to negotiate, we must say that Government people have been more than helpful. Ministry of Works officials wear collars and ties, drink and eat just like you or I, and smoke cigarettes at 3s.6d. a packet. Sometimes, though, they do a little better with petrol.

“We’ve been greatly assisted, too, by local farmers, who do not subscribe to the view that dairy cows refuse to come across with the milk if they are within earshot of a racing car.

“Naturally, in the J.C.C. we are more than pleased to be staging our first race meeting in England since the war. As someone said the other day, we are a little lucky in having a President with an airfield in his back garden, but it’s better to be born lucky than have to pay 19s. 6d. in the £.”

Today, the Goodwood Revival is a unique, world-class motor racing event. In the last year we have also spent our fair share of time with the bureaucrats and, like Freddie, at times we would have struggled to offer you a seat (the office fit-out rumbles on). But, in time, we aim to produce something we can all be proud of and, we expect that at Nomad you will also see some quite good racing.

An Overview of the Partnership.

Good investing is a minority sport, which means that in order to earn returns better than everyone else we need to be doing things different to the crowd. And one of the things the

crowd is not, is patient. Readers of our letters (there must be some) may be familiar with the notion of the equity yield curve, and our thoughts were covered in an interview for the Outstanding Investor Digest (reprints available upon request, do ask Amanda) a few years ago. (In brief, the equity yield curve is a concept that argues that patience has a value, and that returns increase with time in the equity market as they do on a normal bond market yield curve). In the bond market the higher yield is there to compensate for the increase in risk that the principal will not be repaid, or that the principal may be devalued by inflation. That is not how it works in the equity market: in our opinion business outcomes can be more predictable several years out than they are in the near term. For example, we have no idea where the market will end this year but given corporate strategies, capital allocation and starting valuations, I think we have some idea of how our companies will evolve over the next few years. In other words (at this point economics students may wish to cover their ears) the return from investing in shares can be both increased and de-risked by time.

There may be a blind spot in academia as the overwhelming methodology for research in Economics has been to take observations over short time periods, as if cause and effect sit on top of each other. Habits can take years to form. What, we wonder, would academics have to say of Coke's century long advertising program and the eventual establishment of the World's most valuable brand?

It is interesting to us that Nomad's performance by vintage bears evidence of the equity yield curve. Take the current portfolio: stocks held for over four years have superior *annualized* returns compared to those held for between three and four years, which have higher *annualized* returns compared to those held for two to three years and so on down to stocks purchased last year, which are a pretty mixed affair and contain several losses! The numbers are skewed by survivorship bias (no Consecro) but exclude stocks sold that have continued to do well (notably Stagecoach, which has risen ever since we sold it!). There is opportunity set bias in these numbers too ('02 may be a better year for making new investments than '06) but even so, the steepness of the curve (over 1000 basis points per annum) is cause for optimism, as it implies patience is rewarded. It is with some interest that, on average and weighted by size of holding, the investments in the Partnership today are just over one year old. In other words, Nomad is a young portfolio, perhaps one fifth of the way through its normal life expectancy. The competition is so great that we have little advantage at the short end of the equity yield curve – after all the average holding period of US mutual funds is less than one year – and so one might expect current returns to be so-so. However, if the past is our guide and as the portfolio matures, its best years may yet lie ahead.

How do we know we are taking a different view to the crowd? A clue can be gleaned from the period that other investors typically hold the shares of the companies in the Partnership. If Berkshire Hathaway (US), Jardine Matheson (Hong Kong) and Next Media (also Hong Kong) are excluded (these firms are in a class of their own due to either stock illiquidity or investor education) then other investors hold stocks in our portfolio for on average twenty weeks. We expect to own shares for around two hundred and sixty weeks! So, what is going on? It seems to us that most investors look at the accounting outputs of a company (the reported financial data) as a guide to near term price movements and play the market accordingly. As stated in the investment objective section of the Nomad prospectus our goal is to "*pass custody* (of your investment) *over at the right price and to the right people*". That's what investing is. Zak and I concentrate on a deeper reality: the inputs to future value moves. Our peers are trading shares at the short end of the equity yield curve where the competition

is the greatest, and we are investing at the long end where competition is the least. We respond to completely different stimuli.

Take for example the current controversy at Amazon.com. Last year the company reported free cash flow of just over U\$500m, indeed it has been around this number for the last few years. What is important is that the U\$500m is after all investment spending on growth initiatives such as capital spending, but also research and development, shipping subsidy, marketing and advertising and price givebacks. The firm has been investing in these items today to grow the business in the future so that free cash flow in years to come will be meaningfully greater than it would be otherwise. By our estimates these discretionary investments, over and above that required to maintain the business, are in the region of a further U\$500m, excluding the price givebacks. This is our subjective assessment of the discretionary investment spend and implies that management could, if so inclined, cancel the discretionary growth spending and instead return around U\$800m per annum to investors after taxes. An operation that was able to produce cash flow on such a basis might be worth U\$10bn or so, and along with Amazon's other assets would imply a share price of around U\$26. In valuing the business at these prices, as occurred last summer, investors are saying to Amazon management "your growth spending has no value, you may as well turn yourself into a cash cow"! This is an odd statement to make for a business growing revenues in excess of twenty percent per annum.

How should we think about the price givebacks? Here is what Jeff Bezos, Amazon's founder, had to say in last year's annual report:

"As our shareholders know, we have made a decision to continuously and significantly lower prices for customers year after year as our efficiency and scale make it possible. This is an example of a very important decision that cannot be made in a math-based way. In fact, when we lower prices, we go against the math that we can do, which always says that the smart move is to raise prices. We have significant data related to price elasticity. With fair accuracy, we can predict that a price reduction of a certain percentage will result in an increase in units sold of a certain percentage. With rare exceptions, the volume increase in the short-term is never enough to pay for the price decrease. However, our quantitative understanding of elasticity is short-term. We can estimate what a price reduction will do this week and this quarter. But we cannot numerically estimate the effect that consistently lowering prices will have on our business over five years or ten years. Our judgment is that relentlessly returning efficiency improvements and scale economies to customers in the form of lower prices creates a virtuous cycle that leads over the long-term to a much larger dollar amount of free cash flow, and thereby to a much more valuable Amazon.com. We have made similar judgments around Free Super Saver Shipping and Amazon Prime, both of which are expensive in the short term and – we believe – important and valuable in the long term."

This is a précis of the scale efficiencies shared model that we dealt with in some detail in our analysis of Costco (Nomad Letter to Investors, December 2004, please ask Amanda for reprints) and is deployed by companies which have now come to dominate Nomad: Costco, Dell, Amazon and Berkshire (Geico, Nebraska Furniture Mart). The controversy is in the first four words "As our shareholders know", judging by the share volumes - they don't! And that's the opportunity. If the share price is being set by those with an eye on the next data point, then they can't also be looking out for long-term value. There are few traders that disagree with

Bezos' value creation process, but they don't think it will show up in the numbers just yet. And if you only own shares for a month or two then you may get away with several trades before Amazon's success becomes apparent. In short, the traders have many small ideas, and we have one big idea. Good luck to them. Picking up pennies in front of a juggernaut is just not how we behave.

Notice also that the decision to lower free cash flow this year through sharing scale benefits with customers through price givebacks is based on a subjective judgment of future returns and their timing. It is not a strictly maths based equation and there is no guarantee that investment spending will always work. Bezos again:

“Math-based decisions command wide agreement, whereas judgment-based decisions are rightly debated and often controversial, at least until put into practice and demonstrated. Any institution unwilling to endure controversy must limit itself to decisions of the first type. In our view, doing so would not only limit controversy – it would also significantly limit innovation and long-term value creation”. Amen.

I think Bezos would run a good investment fund: but that is the point, good investing and good business decisions are synonymous. Mr. Bezos does not control the timing of the payback, just as we do not control the timing of Nomad's performance but, in our judgment, the ever widening of the moat surrounding Amazon largely determines whether our investment will be a success. We must now have the patience to wait.

Today Nomad is close to fully invested and notably concentrated: the five largest holdings account for half the portfolio and the top ten around three quarters. The tail of around twenty other holdings includes baskets (such as Zimbabwe), several distressed turnarounds and rats and mice from the early days. The polarity of the portfolio, with several large, simple, high conviction holdings, and a tail of more complicated and less certain ideas (but which may have more upside) is likely to be a feature of Nomad for some time. There is a notable concentration in US stocks, a factor that also contributed to relative performance last year, while there are some interesting UK investments where we may have some influence on corporate development. The price to value ratio of the Partnership as a whole is in the upper 60 cents on the dollar, having risen from the low 60s in October.

Why do Problems go Unsolved? Because they Fall Across Disciplines

Whilst Zak and I are delighted at the doubling of the value of Nomad shares between 2001 and 2004, this would be for nothing if returns had been given back in the last two years. As it is, we have been able to reinvest the portfolio in new opportunities and the fund has continued its rise. There are several funds that, over the last few years, have created a similar track record to ours by investing in specific countries (Russia, India, Egypt etc.) or sectors (gold, oil, basic materials). Investors with holdings in the fields listed above should be aware that more narrowly focused funds will find it hard to maintain their performance if the bull market in their fields starts to fail.

What we are saying is that because so many fund managers are constrained by their mandates excess returns ought to exist for the unconstrained. The turn-of-the- millenia technology fund manager could not invest in Stagecoach (a bus operator) even if he had wanted to. For this reason, it seems to us that there is more to the private equity boom than just low interest rates.

In a world where traditional fund management is compartmentalised by attributes such as geography, sectors, investment styles (value, growth, garp, momentum), tracking errors, beta, listed or unlisted status, (stay awake at the back) equity or debt, bankruptcy or solvency then those with broader powers, such as private equity, and indeed Nomad, should have an advantage over constrained incumbents. Woody Allen once quipped that being bi- sexual doubled the chances of a date on Saturday night, curiously that principle also applies to investing.

Rules based systems always contribute to societal non-thinking, but it's not the mandates so much that are the source of risk to investors in constrained funds. It's the attitude of the non-thinkers running the funds that is so destructive. The following excerpt taken from the December 2003 Nomad Letter to Shareholders summarizes our views:

“The Weetabix offer is only one of many privatisations of cheap, small and mid capitalisation businesses in the UK. Institutional shareholders have abandoned these firms in favor of mega-caps, and the shareholder base is left dominated by one or two inside interests and a tail of small holders. Our view is that the discount that the shares trade at in the market is an asset to be harvested for the benefit of all shareholders through share repurchase. But human nature being as it is, insiders will be incited by the low valuation to buy the shares for themselves. A Scheme of Arrangement is the most ruthless method of asserting one party's will over a fragmented and non-professional shareholder base and coupled with irrevocable acceptances allows takeover offers to be presented as a fait accompli to shareholders. Please note: bad practice spreads. Despite this, and the almost daily occurrence of privatization proposals in the UK, there has been almost no criticism by shareholders, the authorities or in the media. In no other sphere of capitalism can your property be seized in exchange for cents on the dollar (except compulsory purchase on the grounds of national interest). But fund managers, who in their private capacity would be insulted if someone offered less than their house was worth, happily sell shares in their professional capacity at discounted prices to smart buyers. And no one cries foul.”

The fund managers understand what is going on. These are intelligent, highly paid individuals who could defend their clients' interests much more vigorously. They could, for example, own much more of the target company and block the bid. Or, if mandate constrained to only invest in listed equity, why not explain the situation to their clients and seek to change the rules of their funds to allow ownership of, say, unlisted equity? But not a squeak. Many fund managers would rather sell your shares for a small takeover premium now (and market their short-term performance to new investors) whilst turning a blind eye to the doubling in the value of the sold business over the next few years. It's a scandal.

The December 2003 letter again,

“Whilst we have a profit on our investment in Weetabix, shareholders should be careful what they wish for. Before congratulations are in order, Partners need to weigh in their minds short-term profits against value forgone in the discounted offer price and the incentive provided by the success of seizure for potentially more of the same in the future.”

Just look at what is happening in the markets now: 2006 was a record year for private equity funds. As the bids often come from the private equity fund operating in joint venture with

management then, in our opinion, they are best understood as insider trading with the takeover rules being used as a bulk purchasing facility. In the UK (and some former colonies) there is some protection against corporate wallet lifting as dissenters (those wishing not to sell) cannot be compulsory acquired if they own more than 10% of a company. The situation is far worse in many other countries – for example in the United States there is no universal protection against compulsory purchase! Back to the December '03 letter:

“So, what is to be done? The best defense is to own enough of the company to influence the outcome. In most cases [in the UK] 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.”

To this end Nomad is now the largest shareholder in Games Workshop Plc., a significant shareholder in Jarvis Plc., and part of the dissenting group at Whitehead Mann Plc.

Whitehead Mann has a reasonably entrenched position as the largest headhunter to FTSE 100 CEOs and used this cyclical revenue stream to fund the acquisition of several competitors (often with insiders cashing out!). As revenues declined the interest burden overwhelmed failing cash flow and the share price declined from a peak of £4 to around 50p when we first went to meet management two years ago. At the time the firm was seeking more capital in the form of a bankruptcy avoiding rights issue and placing. It seemed odd to us that the insiders were not buying shares in the firm along with their shareholders and so we declined to participate, “we’ll be bullish when you are bullish” we told the MD. Even so, capital was raised at 40p per share from other investors and we sat and watched from the sidelines. Then last year the company announced that management, along with a private equity fund, were offering 42p to buy the whole company and had secured irrevocable undertakings from shareholders to purchase around seventy percent of the shares outstanding. In other words, having saved the company investors were being offered a return of 2p (five percent) for their trouble! And insiders, who had chosen not to invest in the bankruptcy-avoiding placing, now wished to buy as much as they could (via the bulk purchasing facility) and so we also made an investment. Today we are part of a dissenting shareholder group that own around 19% of the shares, enough not to be compulsory acquired. As we will continue to own our unlisted shares we propose, in the absence of more information, that the shares be valued in Nomad at the takeover price (42p) plus (or minus) retained earnings. We look forward to seeing what management can do for us, now they have (leveraged) skin in the game.

Some Housekeeping

Contained in the appendix of this letter is a copy of the schedule of investments at year-end (please hide under your mattress) and the two letters we sent to Partners last year, one that outlines the philosophy of our operation and the second the methodology of the performance and management fees. These are important letters and are reprinted here for your reference.

Your first port of call with enquiries as to performance and valuations should go to Gavin Gray and his team at Phoenix Financial Services in Dublin, Ireland. They can be reached at +353 1 845 8161, do call them! Gavin was one of the few administrators prepared to rise to the challenge of our non-standard cost-reimbursement management fee and redeemable

performance fee. Whilst other administrators wished to shoe-horn Nomad into an existing cookie cutter, for the same money Phoenix will administrate our bespoke arrangement. Over time that will prove to be a considerable saving in fees paid by Partners. We have found Gavin and his team to be intelligent and helpful and we are glad to have them along. Amanda Joss (+44 20 7101 1960 and amanda@sleepzakaria.co.uk) can help with literature, reprints and diaries, and directions to the office can be found on our, somewhat homespun, web site (www.sleepzakaria.co.uk). On viewing our web site some friends, perhaps with higher technical aspirations than ourselves, asked: "is that what you want?" It is! We will leave the web-pyrotechnics to Amazon.

We write these letters and hope to provide you all the useful-to-know information about Nomad and us. This is the information we would want to know if we were in your position. We shy away from more frequent reporting which risks say-something syndrome and at worst may provide a meaningless comfort blanket. Any psychological security you receive from us should be a product of our attempts to be more rational than the crowd.

The portfolio feels fresh and young and is healthily out of step with consensus. Many holdings are companies of real character and product integrity, in contrast to stocks held a few years ago. New ideas are coming into the hopper at a good rate and Zak and I are unrestrained to think and research in a way that has not been possible for some time. We are acutely aware that whilst our record may be the tripling in the share price (before performance fees), one in seven Partners and around seventy percent of the dollars invested in Nomad are new since September 30th 2006. Nomad is up around ten percent since then and, in the scheme of what we do, that is hardly worth the comment. It seems healthy to us to see the clock as substantially reset by the increase in funds under management, and in no way are we resting on our rolling performance numbers. In many respects it is day one all over again.

As ever, it is an absolute pleasure running the Partnership. We thank you for the opportunity to do so under our own steam and for your patience and confidence in us,

Yours sincerely,

Nicholas Sleep

*Sleep, Zakaria and Company was appointed as investment advisor to the Nomad Investment Partnership with effect from September 12th 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 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.

Appendix II

As you may already know, Zak and I recently left Marathon to manage the Nomad Investment Partnership full time. In some respects, this does not represent much of a change from the status quo, as Nomad had come to dominate our time and thinking. However, some things will be new, and the purpose of this letter is to set out the philosophy of our new operations. This will give you time to think about their implications before we set out the methodology in a revised prospectus. The changes in the prospectus will require your vote, and of course, at any stage Zak and I will be free to answer any questions you may have and our contact details are at the bottom of this letter.

Between us, Zak and I have spent sixteen happy years at Marathon. It was a superb education, and in many important respects working with Jeremy has made us the investors we are today. We all remain close and indeed attended the Berkshire Hathaway AGM together last week. It is perhaps indicative of the friendship and out- of-the-box, non-consensual thinking that is typical of Marathon that an amicable, common sense arrangement, such as the spin of Nomad, has been proposed. Few institutions would behave so well.

Zak and I will only be in a position to manage Nomad once we have FSA authorisation to operate as a regulated fund management company. This largely administrative process is expected to take at least three months and along with the remaining duration of our employment contracts (until June 30th) means that, at soonest, we will be in a position to run Nomad from early July. In the meantime, Jeremy will be in charge and will liaise with Zak and me when appropriate. For the next two months we will be setting up a somewhat modest office (it appears that galactic headquarters is likely to be above a shop and opposite a Chinese restaurant in west London!), and configuring the necessary IT, legal and accounting systems. There will be time for research, and Jeremy has been kind enough to send on a formidable pile of annual reports! So, Nomad is being looked after in the meantime.

Our new company will be called Sleep, Zakaria and Company, Limited (catchy) and we will manage one fund, the Nomad Investment Partnership. I expect this statement to be as true in twenty-years' time as it is today – Zak and I are not in the product diversification business. Indeed, we don't really see the new company as a business in the usual way: for example, we have asked our lawyers to structure the arrangement so that Zak and I could not sell Nomad to another fund manager – that way you will not wake up with someone else managing your money whilst your manager catches a plane to Hawaii! You can sack us, but we won't sell you. Perhaps an explanation of our proposed fee scale will make clear our orientation.

The Nomad Investment Partnership currently charges a management fee of 10 basis points per annum, a levy which leans somewhat on the in-place infrastructure at Marathon and which is insufficient to sustain a stand-alone operation. We would therefore like to propose a new management fee that will reimburse the operating company (Sleep, Zakaria and Company, Limited) for its costs incurred in running the operation (salary, rent, accounting, research, legal etc.). We guesstimate this will be between 0.7% and 1% of the Partnership per annum at

its current size, and we will cap the reimbursement at 1% of NAV and fund any deficit out of pocket if need be. Philosophically our position is that the management fee should not be a profits centre (although a small surplus float is prudent). This is not a blank cheque: Zak and I will take a salary cut to run Nomad, and a total remuneration cut that questions our sanity, but as I have said, this is not a traditional business. As the Partnership grows in size the management fee will decline as a percentage of assets and, that way, all investors share in the natural scale economics of the operation.

The performance fee also needs addressing, as there is an inconsistency between multi-year investments, multi-year orientation by investors and an annual payout for the manager! The performance fee should be appropriately calculated for the job, be at risk for subsequent poor performance and reflect the cost of capital. We will therefore propose that the existing six percent cost of capital hurdle remain (approximating five-year bond rates) and that the performance fee be deferred and subject to repayment in the event of subsequent underperformance. There are several ways this could be achieved, the easiest of which may be to bank the performance fees, and for the bank to drip fees to us if performance remains reasonable, or drip reimbursements back to you to the extent we fail to maintain our advantage. One way our advantage may be compromised is if size becomes a meaningful drag on performance, as I said in the last letter to investors *“our ability to expand and shrink will be an important tool sometime in the next twenty years. I guarantee it...”*. Our intention is that *“the bus is always running at full speed with the number of passengers optimised to maintain maximum speed”*, and so we will also take powers to return cash to you should we find the opportunity set is small. I don't expect that we will return cash to you that much, and I would be delighted if we did not at all, but it seems silly to set off without the ability to do so. Again, the prospectus will elaborate.

The investment philosophy and methodology will be unchanged. All that changes is that Zak and I will be dedicating one hundred percent of our time to Nomad, rather than something less than one hundred percent, and that one hundred percent of our personal investments will be in Nomad, rather than something less than one hundred percent. Otherwise, it is business as usual and there will be no change in our fund administrator (Daiwa Securities Trust and Banking in Ireland) or auditor (Ernst and Young).

Zak and I are delighted that Marathon has allowed us to continue running Nomad; it is a generous gesture on their part. We are proud of what we have achieved at Nomad (as well as at Marathon) but no matter how noble Marathon's gesture is, it will mean nothing if it is not endorsed by you. Keeping existing investors has always been more important to us than acquiring new, and this transition will only be a success if you make it so. So, I encourage you to read through the Collection of Letter to Partners sent to you in January (Amanda Joss ajoss@marathon.co.uk can help you with reprints) and the prospectus you will receive shortly. And if anything is unclear then Zak and I await your call. You may also wish to contact Karl McEneff or Martin Byrne who are the independent directors of the Nomad Investment Company and Marathon (Cayman), which is the General Partner of the Nomad Investment Partnership. Karl and Martin are superb council and have your best interests at heart.

Zak and I are skipping happy about the new arrangements. We hope you will be too.

Yours faithfully

Nicholas Sleep

Appendix III

Since Nick last wrote to you in July, he and I have been busy dotting countless i's and crossing innumerable t's allowing us to place before you the changes we would like to make to Nomad's fee arrangements and structure now that its management is to be transferred to our company, Sleep, Zakaria & Co. Ltd (SZ & Co). The changes will become part of the Nomad Investment Partnership's (NIP) new partnership agreement and it is our intention, following the handover from Marathon on the 12th of September, to put these changes before the NIP partners seeking their approval. The largest partner is, of course, the Nomad Investment Company (NIC) itself and that's why the board of NIC are writing to you to seek your authorisation to vote in favour of the changes to the NIP partnership agreement. It is part and parcel of the madness that permeates the investment world that there is no requirement that they seek your vote! But we all (Nick and I, as well as Martin Byrne and Karl McEneff, your company's two independent directors) feel it entirely appropriate that your views count. After all, we are proposing to change the contract you have with us, the basis on which we are entrusted to invest your money. Nick, Martin, Karl and I are happy and available to field any questions you have.

The Changes

First, why make these changes and why now? Nomad will move from under the wings of Marathon to our company on the 12th of September, allowing Nick and I the freedom to put into practice our philosophy to minimise wherever possible the conflict between principal and agent. This is easier said than done. It's disconcerting how invasive the conflict has become in the field of investment management (students of Jack Bogle will not need reminding) and, as you might expect, money lies at the root of this particular evil. So "job one" for Nick and I is to establish an equitable fee structure which reflects our wish that partners (the principals) and Nick and I (the agents) can sit across a table in twenty years with both sides feeling the relationship has been symmetrical and fair. Plainly, this symmetrical form bears no relation to what is now considered the fee structure norm amongst hedge funds and the like. That's fine by us, we wouldn't have it any other way.

Let me explain the changes by way of example...

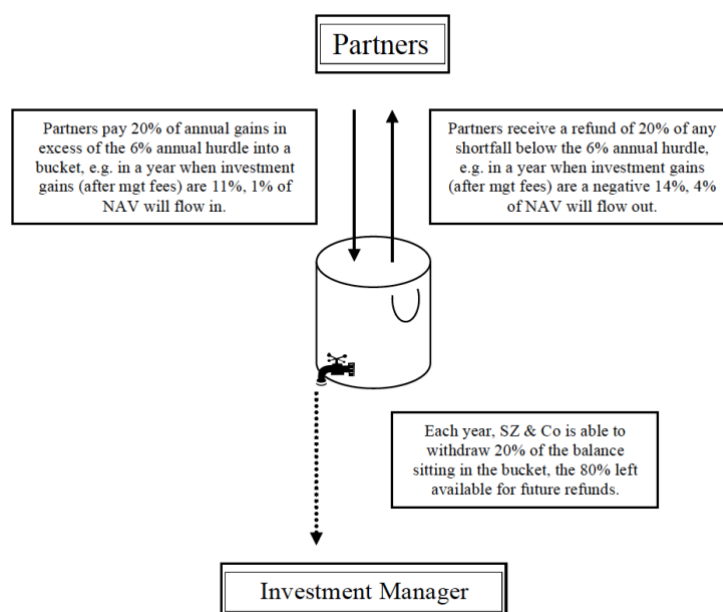
First, the management fee. Currently, a simple, flat rate of 10 basis points per annum (leaning heavily on Marathon's infrastructure), this fails to pay the basic running costs of a stand-alone firm such as SZ & Co and needs to change. The question is, is a higher flat rate equitable? The answer here is plainly, no. An equitable solution is a management fee that doesn't generate a profit for SZ & Co while at the same time accreting economies of scale directly to investment performance. This is achieved by moving to a variable fee, capped at 1%, which re-coups SZ & Co's running costs while management fees, as a percentage of assets, decline as the partnership grows in size. The table below should illustrate...

| Partnership assets | SZ's running costs | Management fees as a % of assets |
|--------------------|--------------------|----------------------------------|
| US\$50m | US\$1.5m | 1% |
| US\$150m | US\$1.5m | 1% |
| US\$250m | US\$1.5m | 0.6% |
| US\$500m | US\$1.5m | 0.3% |
| US\$500m | US\$2.0m | 0.4% |

That’s the simple part over... now to the performance fee. Currently the partnership pays a performance fee to the investment manager if compounded performance, since subscription, exceeds a 6% per annum hurdle, our proxy for long term deposit rates. The fee earned is one fifth (or 20%) of all investment gains in such a year. Although a huge improvement on the industry standard fee structure that fails to assign any cost to investors’ capital, the flaw here is easy to spot. We take a great deal of care stressing that Nomad is an investment only suitable for partners with timeframes in excess of five years, matching our average stock holding period. At the same time, your manager is taking an annual fee, a clear mismatch in the duration of rewards. And what of periods of poor performance? Up to now Nomad has adopted the industry standard “high water mark”, which solely avoids double charging investors for the same performance... this, heads-I-win, tails-I-don’t-lose construct is, to our mind, clearly inequitable. But there’s little out there that improves on this.

Our solution to this quandary (our special thanks to our friends at Orbis in Bermuda who have trail-blazed this path) involves some Heath-Robertson-like innovation, something we like to call a performance fee bucket or, what our lawyers more elegantly term, a “Contingent Performance Reserve” (CPR). What we propose is that each year a 20% contingent performance fee is charged on investment gains in excess of 6% (after the management fee) achieved in that year. Unlike previously, that’s not 6% compounded since subscription, it’s a more demanding 6% bogie each year. And, more importantly, this fee is not paid directly to SZ & Co at the year end. Instead, it is paid into a reserve account, the CPR, the running balance of which is available to *refund* to partners in subsequent years when performance falls short of the 6% hurdle. So, tails we lose and rightly so. To recap, the bucket fills and empties as our investment performance exceeds or falls short of the 6% annual hurdle. So, if Nick and I do a decent job investing, over time, the money flowing into the CPR will exceed that flowing out in refunds, and a positive balance will be created.

The next stage to consider is how the CPR is distributed to our company. What we propose is that SZ & Co is paid, from the bucket, 20% of its running balance each year (on a declining balance basis). This places the performance fees you pay into the CPR at risk of refund for subsequent sub-hurdle performance for, on average, five years. This aligns the duration of our rewards with yours. The picture below illustrates the dynamics.



So, there you have the meat of the changes to the Partnership Agreement. Two secondary effects come from these changes. First, a change of fund administrator from Daiwa to Phoenix Financial Services Limited who, we feel, are best placed to deal with the bespoke nature of our new fee arrangements. We plan to take a performance fee “snapshot” at the end of September, allowing Phoenix to take on Nomad’s administration with a clean sheet in October. Second, and a result of the Daiwa/Phoenix handover, is the resignation of Karl McEneff, Daiwa’s representative on your board, and the appointment of Andrew Galloway as your second independent director alongside Martin Byrne. We thank Karl for his valuable guidance during the handover period and welcome Andrew on board.

We hope to complete the administrative changes to the partnership by the end of September, allowing Nick and I to return to the “day job”, investing...roll on October!

Yours sincerely

Qais Zakaria