

# Sleep, Zakaria and Company, Ltd.

## Nomad Investment Partnership

### Interim Letter

For the period ended June 30th, 2006

This is the inaugural Nomad Investment Partnership letter written under the letter-heading Sleep, Zakaria and Company, Limited. The address may be temporary (it's Zak's home, office to follow in September) but Sleep, Zakaria and Company is where we expect Nomad to rest until we are all old and grey. We write this letter in our capacity as both managers of Nomad in the past, whilst employees of Marathon, and future, with the handing over of the management contact to Zak and my company effective early September 2006. For the period from our resignation from Marathon in March to the completion of the handover of Nomad in September, it is Marathon that is responsible for the portfolio. For this reason, Marathon will be sending you the performance numbers under separate cover whilst Zak and I have written this commentary. This somewhat artificial separation should only be necessary for this letter whilst the handover is pending. From early September head and body will be reunited and we will assume full responsibility for your Partnership. From early September the buck stops here. We can't wait!

This interim letter will also be reasonably brief (do I hear a cheer?) as it falls between two far more important documents which require your attention: the transition letter sent in April (also contained in the appendix to this letter) which outlines the philosophy of our approach, and the prospectus, which will follow shortly, outlining the methodology. In this letter I would like to concentrate on two items, the state of the handover of Nomad to Zak and my company and second, an investment controversy.

#### An Update on the Handover.

*"What's the excuse this time?"*

*Not my fault, sir.*

*Whose fault is it then?*

*Grandma's, sir.*

*Grandma's? What did she do?*

*She died, sir.*

*Died?*

*She's seriously dead all right, sir.*

*That makes four grandmothers this term, Blenkinsopp.*

*And all on P.E. days.*

*I know. It's very upsetting, sir.*

*How many grandmothers have you got, Blenkinsopp?*

*Grandmothers, sir? None, sir.*

*You said you had four.*

*All dead, sir.*

*And what about yesterday, Blenkinsopp?*

*What about yesterday, sir?*

*You were absent yesterday.*

*That was the dentist, sir.*

*The dentist died?*  
*“No, sir. My teeth, sir.*  
*You missed the maths test, Blenkinsopp!*  
*I’d been looking forward to it, sir.*  
*Right, line up for P.E.*  
*Can’t sir.*  
*No such word as “can’t”, Blenkinsopp.*  
*No kit, sir.*  
*Where is it?*  
*Home, sir.*  
*What’s it doing at home?*  
*Not ironed, sir.*  
*Couldn’t you iron it?*  
*Can’t, sir.*  
*Why not?*  
*Bad hand, sir.*  
*Who usually does it?*  
*Grandma, sir.*  
*Why couldn’t she do it?*  
*Dead, sir.”*

“Excuses, Excuses” by Gareth Owen

Anyone who has attempted to set up a fund management organisation will immediately recognise Blenkinsopp. The cookie cutter nature of the fund management services industry (accounting, administration, legal, tax, information technology and so on) means that those attempting to break from the status quo come across more than their fair share of excuses. It will surprise few that our proposed refundable performance fee is not one widely adopted by hedge or mutual funds, or indeed institutional investors, and so no off-the-shelf cookie cutter solution exists. The problem, I shall whisper this next part, may have been that in the not-too-distant past (that is before ninety percent of the world’s hedge funds came into existence) pricing in various parts of the financial services industry may have been too low! Modest slither fee scales have changed little in a decade and ten years ago required product standardisation to stretch a clerk and his computer over many clients, in order to earn a reasonable return on capital for his bank. Today, that is, ten thousand hedge funds later, demand is white-hot and having struggled with per client economics in the early days the cookie cutters now earn super-normal profits.

This Henry Ford (any colour so long as it is black) standardisation also has a nastier side, in the sense that it stifles innovation: Hedge funds can duck the equitable performance fee question (mouth upturned they can validly and conveniently claim that 1% and 20%, 2% and 30% and so on are industry standard fee scales) whilst simultaneously the cookie-cutter accomplice earns super normal profits too. One of the world’s most successful banks told us that they do not have the capacity to service Nomad’s refundable performance fee scheme. A cursory glance at their accounts reveals a twenty-five percent return on equity, of which fifteen percent on equity is retained each year for the purpose of growing capacity! Hubris amongst the service providers abounds: I feel a letter to the Chairman coming on.

Sleep, Zakaria and Company Ltd., which will provide investment management advice to the

Nomad Investment Partnership, has recently been authorised by the Financial Services Authority, and in what may turn out to be record time. As the usual authorisation process takes three to four months and we know of some firms that have taken one year, our four-week approval is testament to Nomad's simplicity. In one delightful exchange with the FSA, they thought we had mistakenly reported in our filing an average of three trades per month (a trade is an individual purchase or sale of a stock or bond, including those triggered by subscriptions). Surely, they asked, you have missed off the noughts? But we had not and indeed the three trades per month statistic (we did argue that we do not trade, we invest: this fell on deaf ears!) misrepresents the facts as our average holding period is around five years.

At the risk of sounding like Blenkinsopp the prospectus will be with you shortly, and we will save a discussion and explanation of its intricacies until then. Marathon's resignation of the management of Nomad (with a forty-five-day notice period) and our appointment as managers immediately thereafter means that Nomad will be managed by Sleep, Zakaria and Co Ltd from September 12<sup>th</sup>. By then we should be in our new office, and there will be a new prospectus. Hooray!

We have been asked many times about reopening the Partnership, so much so that I fear we must have taken a leaf from the Hershey Creamery school of investor relations. Readers may recall that a few years ago we found it difficult to obtain Hershey Creamery annual reports or proxy statements and so we resorted to asking the CFO for a copy, only to be told "these are mailed out to our shareholders". How then might potential investors form a judgement whether they would like to become shareholders without the benefit of an annual report?

*"It's a common complaint",* came the reply.

We do not mean to be so evasive, so let me explain the conditions under which we may reopen. The golden rule is that we will only reopen if incremental dollars bring something to the party, through lowering the price to value ratio of the Partnership as a whole. This aside, any increase in size is also accretive to performance as the management fee in dollars is, within certain parameters, fixed and will decline as a percentage of assets as the Partnership grows. That way growth also offers a saving to all investors. Capital raising will first take place by a rights issue to existing investors with rights not taken up returned to us and then offered to those that have indicated an interest in investing and satisfactorily completed a due diligence questionnaire. The queue is ordered with principals ranked above agents, and agents ranked according to various criteria. However, it is not ranked according to the size of the investor's pot. It is far more important to us, and our existing partners, that we all see Nomad in the same light – we simply do not have the will or inclination to offer bespoke services, cater to a different crowd or to be particularly large. When it comes to the Partnership opening, we are happy to adopt the motto of the Brooklands Motor Racing Circuit whose pre-war posters showed cars speeding around its famous banked corner whilst well-dressed spectators ate picnics on leafy verges, with the slogan "*the right crowd, and no crowding*". We are very respectful of the trust existing partners have placed in our ability to compound their savings and have no appetite to pack in all and sundry, regardless of the incentives.

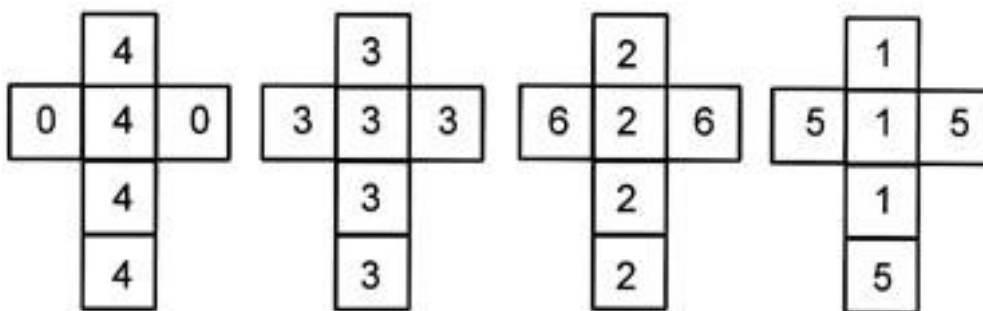
I am sure we would make poorer investments if we did and be unhappier to boot!

When we find a pool of good ideas of reasonable size, we will be in touch. However, we will

not open just because Nomad will be independent or due to some dreadful manifestation of the principal agent conflict. The cost-reimbursement management fee means we do not need to open to put bread on the table. To date, we have turned U\$1 into around U\$2.70. Our aim is to turn this onto U\$10 within a decade (approximately fifteen percent compound per annum) and we are somewhat indifferent as to how much money we carry with us during the process: For Zak and I, it is all about the destination.

### Non-Transitive Dice and some of the things they tell us about investing

If  $a > b$  and  $b > c$ , then it would normally follow that  $a$  is also  $> c$ . This is a transitive sequence and is embedded deeply in our mental problem-solving apparatus. It all seems quite logical. Non-transitive, or “magic”, dice challenge this assumption. A set of magic dice contains four dice whose faces are labelled as follows:



To play magic dice a host invites an opponent to choose one dice, which the opponent will roll against the host, the one with the highest number wins. The process is repeated and it's best out of ten. Some players might choose the dice with the numbers five or six, without observing the number's frequency. Others may reject the dice with zeros (surely that can't win a round?) without observing that the dice's four fours beat the number three dice two-thirds of the time. As displayed in the diagram above, the dice on the left beats the one on its right, and so on across the diagram, but the dice on the far right also beats the one of the far left! It would appear that if  $a > b$  and  $b > c$  that  $c$  is also  $> a$ !

Of course, there is nothing magic about it, but at first the circularity appears counter-intuitive. A winning dice thrower must correctly assess the probability or frequency with which a dice will produce a superior number, after all a winning dice may not win on the first throw. And the dice thrower can only answer that question if first he knows what dice he is up against. The trick is to allow your opponent to unwittingly reveal some more information and get him to pick a dice first!

Non-transitive dice offer two handy investment models: first, just as any dice can win for a while, so any superiority an investment process may have will only emerge with time, so patience is important. Second, the stock market posts prices every day, this is the equivalent of making your opponent chose his dice first. The prices the market sets reveals information about a company's prospects which may or may not provide an opportunity, it is up to investors to either take the market up on its offer, or wait for another price, another day.

The 1960 Buffett Partnership letter to investors included the following observation that we

also carried in the June 2002 Nomad interim letter:

*“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 poorer-than-average performance in rising markets”.*

Our performance is following a similar path of superior results during market swoons and now reasonable absolute, if a little less than average, results during market booms. Indeed, the only time we have been ahead of the index year-to-date was during the market swoon in May and early June. The stock market is booming, perhaps more than is apparent in the indices as the action is taking place in lowly represented sectors and the privatisation of smaller companies (as the cycle develops this is sure to end in a truly big privatisation). There has been much market commentary offering evidence for a bubble in commodity prices and the valuation of commodity stocks. The evidence, as such, has centered on the high price of commodities compared to history, the resurgence of investment banking activity in the sector, media column inches devoted to the subject, the price of real estate in northern Alberta and so on. New Era theorists argue that China and India offer a here- to-unexperienced demand boost, whilst protagonists throw up their hands in disbelief at commentary referring to a New Era so soon after the last ended in collapse.

What strikes us was the evidence for stock market excess: in short, something is up in the global capital markets when investors' average holding period for Phelps Dodge stock, a relatively sober copper mining company, is three months. This is not normal for any business let alone one whose assets last for decades. Investors typically hold stock for around two years, although the average mutual fund manager holds shares for around eleven months according to Vanguard founder, Jack Bogle. However, frenzied trading is not uncommon, witness six week holding periods for Yahoo in 1999, or in the Malaysian Second Section in 1997, but it is frequently associated with investor uncertainty, and speculation.

Prices are a language, and the U\$20bn equity market valuation of Phelps Dodge states that, with no margin for error, the business will earn record levels of free cash flow for the best part of the next decade and with no decline (in nominal terms) in terminal value. Maybe so, but the frequency with which investors change their mind implies this is hardly a stable statement of fact. Let's be more blunt. There is an inconsistency between the multi-decade New Era-like prediction embedded in the share price, and the lack of will to see that prediction through. It is almost as if investors know it's a lie. This is not an isolated event, according to the research boutique, Empirical Research Partners, oil service companies holding periods are equally truncated and the firms are valued three or four times more highly than their customers (shades of Cisco circa 1999?).

In a traditional capital cycle framework, the high valuation of these businesses encourages a supply side response, which eventually undermines the economics discounted in the stock price. The operative word here is “eventually”, so how long is eventually? Company reports this year show an expected increase in capital spending of around forty percent compared to 2005. However, in our opinion, managements tend to low-ball forward capital spending plans for fear of upsetting investors, and so it may be reasonable to expect that spending will surprise on the upside. One Wall Street guru used an American football analogy “management used to be blocking and tackling for us, now they see themselves in the

glamorous receiver position". Indeed, human nature being as it is, we can almost guarantee that capital spending will continue to grow until share prices decline.

We cannot be certain when the tipping point will come. For such stocks to be a viable investment for Nomad we would have to feel confident that sector economics are not discounted in prices several years out and, given the rise in capital spending plans, that is not the way to bet. And this is Nomad's great strength. By looking out five years we do not have to invest in shorter-term phenomena in order to look good this year. And in our opinion that is at the heart of what is driving the frenzied trading in Phelps Dodge – the desire to look good this year, quarter, month, week, or just today.

When there is a frenzy of activity in one area of the market there is very often an anti-bubble of discarded companies. In the dot com era these were companies with steady cash flow. Where is today's anti-bubble? Perhaps in large high quality growth businesses that appear cheaper to us than for many years. It is for this reason that Nomad's largest holdings are dominated by traditional growth stocks, in contrast to five years ago when we owned the detritus of the New Era boom. It is interesting to note that five years ago although the most despised stocks were extremely cheap, each individual opportunity was relatively small (our investments in Stagecoach and Midland Realty were seven-baggers but the opportunity size was perhaps US\$20m each). Today the discount to fair value of the most despised stocks would appear to be much less (doubles over five years are more likely than spectacular multi-baggers) but the dollar size of each opportunity may be greater. The case for a Nomad reopening rests on this observation, and our job over the next few months will be to analyse this proposition.

We will write to you shortly introducing the new prospectus, and hopefully our change of address, new office phone numbers and so on. In the meantime, our contact details remain unchanged and are listed in the appendix. At Marathon, Amanda Joss ([ajoss@marathon.co.uk](mailto:ajoss@marathon.co.uk)) can help you with your enquiries.

As ever, it is an absolute pleasure to be associated with this Partnership. Zak and I value your confidence in us very highly and thank you for your patience.

...off to deal with Blenkinsopp.

Yours sincerely

Nicholas Sleep

Counsel writes: 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.

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## Appendix

### Letter sent to Nomad Shareholders, April 2006

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 30<sup>th</sup>) 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](mailto: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