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Nomad Investment Partnership

Annual Letter For the period ended December 31st, 2007

To December 31st, 2007	<u>Nomad Investment Partnership</u> *	<u>MSCI World Index (net) US\$</u>
Trailing:		
One year	+21.2%	+9.0%
Two years	37.7	30.9
Three years	50.4	43.3
Four years	83.6	64.4
Five years	229.7	118.8
Six years	234.0	75.3
Since inception (Sept 10 th 2001)	269.0	81.6
Annualized since inception		
Before performance fees	+23.0%	
After performance fees	+19.1%	+9.9%

The figures above are unaudited, presented on a cumulative basis and, as ever, the results are presented before performance fees. We present results in this way as the time dependent performance fee hurdle means that partners will have different net-of- all-fees results. 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 31 st , 2007:	<u>Nomad Investment Partnership</u>	<u>MSCI World Index (net) US\$</u>
Calendar Year Results:		
2007	+21.2%	+ 9.0%
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 th 2001)	+10.1	+3.6

The effect of the performance noted above is that the value of a dollar invested in Nomad at inception would now be worth around U\$3.70 before performance fees and just over U\$3 after fees. A similar amount invested in the index mentioned above would be worth around U\$1.80.

When I finish writing these letters, I am happy with them, at least happy enough to send them out. I make a habit of re-reading them sometime later and frequently they disappoint. It is as if the letters have a short shelf life. I am not sure they do go downhill particularly, it's just that they did not start that high up the hill in the first place: the mind thinks they are better when just finished than they really are. It is like the freshly painted wall; it looks good as you reach for the cup of tea at the end of the day but give it a week and all you can see are the bits you missed.

The last letter, for example, is very complicated. There are many heavy concepts introduced one on top of another and it is hard going to read. This is particularly annoying as investing is, at its heart, a very simple discipline. Simple, perhaps, but not easy. And judging by my efforts, certainly hard to communicate. So why are letters more complicated than they need be? Probably because we feel a self-imposed pressure to say something, especially something new or (better and) impressive. The truth is that there is not that much to say, at least, not much that hasn't been said before. That's the curse of being two thousand years younger than Saint Paul, forty- four years younger than Charlie Munger and twenty-nine years younger than my father.

We will return to this topic later in the letter. Today, however, we do have something to add, at least we think we do, and the topic for this letter is mistakes. In this letter we will discuss how we think about mistakes, why the response to the mistake is often more important than the mistake itself, and some of our investment mistakes. We will then discuss why client reporting pressures encourage non-rational thought (a mistake in the making?), provide further encouragement to partners to focus on what we control, and announce a change in housekeeping that may be of interest.

How we think about mistakes.

"If I had to live my life again, I'd make the same mistakes, only sooner".

Tallulah Bankhead (actress)

In our opinion, in dealing with mistakes the best state of mind is non-judgmental forgiveness. Parents will recognise that if their child thinks right, they will make mistakes, work it out for themselves and learn. They do not need to be judged or punished: instead, they need support, from themselves and others. If they do learn, then the mistakes are likely to be small compared to the value of what has been learnt. In investment terms, once lessons have been learnt, mistakes can be put on a price earnings ratio of one and the resultant, conditioned, good behaviour on a ratio of more than one. In other words, mistakes become net present value positive.

So why is it that investors are so unforgiving when a company disappoints? If we apply the model above then there is not a problem. If the market was rational and the company an organisation that learns, then the stock price should rise after a mistake. But this is seldom the

way the world works. It is as if investors presume that companies do not learn from their mistakes. And that makes some sense, as many organisations struggle with rational behaviour. We wonder if investors' anger is a sub-conscious admission that they invested in a non-learning organisation? An unintended consequence of this is that the financial services industry is structured to allow the embarrassment, frustration and anger to vent through the various asset classes. It is structured to allow investors to be judgmental rather than forgiving. You can just hear people justifying their purchase of a gold fund because that idiot who ran their technology fund made a mistake. And he may have. However, if he learnt from his mistake then the value of the fund, properly calibrated, is likely to be rising just at the time investors are selling. There is not a lot of love going around, in the sense of love for one's fellow man, and because of this there is less learning than there could be.

That is not our model.

We (strapping on the protective armour of the first-person plural) have made lots of mistakes. (I will be less cowardly) I have made lots of mistakes. Sometimes we made the mistakes ourselves. Sometimes we learnt from others. Sometimes they were direct investment mistakes. Sometimes they were part of growing up (look out for those private mistakes, they are full of investment lessons). But there they are. Warts and all. This is how life is. We do not justify them, but we do not condemn them either. Indeed, they are best not judged. Our model is to learn from our mistakes and what we learn we hope to give to you, in better performance results (in exchange for a performance fee!).

One way we do this is to practice what we preach and invest in businesses that have made mistakes. Our current investments in Liberty Global, Games Workshop, Dell, Sony and Ford fit into this category, as do previous investments in firms in bankruptcy such as Telewest (now Virgin Media) and Calpine. For these investments to work over the long haul, what is required is a rational, honest mea-culpa and a low share price. The unforgiving nature of the markets often provides the latter. The former is much harder to come by.

Why the response is more important than the original error

"Life is ten percent what you make it and ninety percent how you take it."

William James (philosopher)

We all make mistakes. What is often more important is how one responds. Take for example the response of two firms to the same mistake. The mistake was to be caught out by the last major property downturn in the early 1990s. The two firms are: MDC a residential property developer, and a sizeable European bank with a large commercial property loan book which, being far better capitalised than SZ and Co, we will refer to as Bank X.

MDC was founded in 1972 by Larry Mizel with U\$50,000 in capital. In the 1980s his firm built condominiums and apartments and as the property cycle matured reinvested profits and available borrowings in land for development. This is a classic property cycle error and dooms the purchaser to buying at high prices and leaves little financial flexibility during a downturn. By the early 1990s, revenues had almost halved from the 1988 peak and the firm was left with too much debt and tracts of undeveloped land. The firm averted bankruptcy by selling assets, issuing shares and repurchasing debt at cents on the dollar. The family learnt from its experiences and since then the land bank has been kept to a minimum, debt has been used with great reluctance, and equity capital freed from house sales has been used to equity fund

the next venture, pay dividends or, to a greater extent, retained on balance sheet. Whilst management may have learnt their lesson it must have been galling to have pointed out by an investor at a recent presentation “*you are going to run out of land*”! Plus ca change. The MDC share price has risen ten-fold in the last ten years, despite recent industry wide declines in share prices, and today the firm is one of the best capitalised in the industry. It will be interesting to see how they respond to the current industry crisis.

Bank X made similar mistakes in the late 1980s through extending loans to commercial property businesses, although here only a dividend cut was required to repair the capital deficit. According to a company spokesman the lesson learnt from the debacle was that the bank “*could not do commercial property*”. Companies often misclassify their mistakes in terms of outputs rather than inputs, and in so doing allow the original mistake to go unchecked. Psychologists call this denial, and we all do it to some extent. But it was a false lesson. It was not commercial property per se that was the source of the losses, there is no a priori reason why a lending institution cannot make loans to commercial property as this bank continued to in say, residential property, or credit cards. In our opinion, the mistake was in how the company approached commercial lending: it was in how they thought and how senior management were incented to think. However, instead of responding to the mistake by rewiring the corporate cognitive functions the firm condemned the output and diversified internationally and developed investment banking and an investment management operation, as if to dilute the risk. This is a take-three-wives-just-in-case approach and it works in terms of corporate longevity but is rarely equated with share price success: in the trailing ten years the shares of the bank have risen in the order of ten percent, or around one percent per annum. A deposit account at the institution would have returned far more.

There is a second lesson embedded in the contrast between MDC and Bank X, and that is the popular wisdom that diversification lowers risk. This maxim, as homely as apple pie, is fraught with danger. Its ascendancy into the unchallengeable heights of received wisdom comes from the vivid image of seeing one’s nest egg disappear because of one mistake. What is not recorded is the cost of the suboptimal outcomes that result from over-diversification which range from lack of investment work, high fees and, most dangerous of all, complacency which allows one to ignore the only real, long term risk, which is the risk of misanalysing a company’s destination. Take for example the salami slicing of loans that are embedded in securitisation trusts. Diversification used in this way tries to turn ignorance into an asset. There is something of the zeitgeist in this behaviour: companies routinely subcontract parts of their operation in the name of efficiency, in effect salami slicing their operations into narrow functions. This looks efficient, at least as captured by the profit and loss statements in the early years, but few firms ask: what is lost in this process? Sometimes what is lost is control of subcontracted operations such as Mattel’s Chinese sourced toys, or the BBC’s documentary of The Queen. But mostly it is a lack of trust in the institution by the customer and, unfortunately, this sentiment is often reciprocated. If you know a mortgage sold to you by a commissioned pimply youth now resides in one of many hedge funds’ balance sheets you will feel differently about it than if your branch manager, who has known your Dad for fifty years, still has it on his books. And the pimply youth feels differently if all he has to do is sell your mortgage. Depersonalisation inevitably leads to customer disloyalty and commoditisation, and that is not good for long term profitability, regardless of what the profits account reads today.

How mistakes can become net present value positive.

“It is always a delight to observe other people’s mistakes”.

Anon (Rather, I have not found the source before publishing!)

There is a philosophical argument that a mistake is only a mistake if you call it so, otherwise it is a learning opportunity. That seems like the right spirit to us. Our two biggest analytical mistakes (sorry, learning opportunities) to date were probably Conseco and Stagecoach. We have written about these errors extensively in the past, but in the spirit of the quote above I will précis: Conseco went bankrupt after losses in its manufactured housing loan securitisation trusts impaired capital at its insurance company and A.M. Best, the insurance industry rating agency, declared the business inadequately capitalised. Our analytical mistakes were multifarious, but the most serious was to anchor on analysis at the time of purchase to justify continued holding. The immediate dollar loss was around U\$5m for investors in Nomad. However, the opportunity cost loss, the dollar loss adjusted for subsequent Nomad performance (a fairer reflection of real costs) is around U\$10m.

Stagecoach was a success in the sense that shares purchased at 14p were sold at a high of around 90p. That is until one looks in the Financial Times to be reminded that the shares currently trade above £2.50. The mistake was to leave £1.60 on the table and was also caused by anchoring on the original purchase decision analysis (which required a value above 14p), rather than thinking about the destination for the business in years to come. The opportunity cost of the Stagecoach mistake is broadly U\$12m today (and counting).

The analytical mistake in both cases was to have a static view of a firm formed at the time of purchase, which failed to evolve as the facts changed. This error was reinforced by misjudgments such as denial (the facts had changed) and ego (we can’t be wrong). There was also an over-reliance on price to value ratio type analysis, which can encourage a tighter range of outcomes than occurs in reality. And what did we learn in Investing 101 from Lord Keynes: *“better to be generally right than precisely wrong”!* At the time we were making these errors we would have held Keynes’ quote as true. One has to be so careful; sometimes these mistakes are very insidious. Keynes’ dying words were reported to be *“I should have had more champagne”*. No doubt he is right on both accounts.

Destination analysis is consciously central to how we analyse businesses these days. It helps us ask better questions and get to a firm’s DNA. What we learnt at Conseco may well have kept us out of the US banks last year, and what we learnt at Stagecoach has helped us continue to own Amazon. These two benefits have been a combined gain in the order of U\$60m during 2007 to investors in Nomad. The maths behind this assumption is a little finger-in-the-air and is unadjusted for subscriptions post mistakes, but it is directionally correct and implies that a large proportion of Nomad’s performance in 2007 came from the lessons learnt from mistakes in 2003 and 2004. Think of it as a return on prior year losses. And that is just one year’s gain. If we have really learnt our lesson, then the gains will continue in future years too. In the meantime, we continue to bear down on denial and ego too!

Tips on how to avoid making mistakes

Understanding how the intellect can become corrupted is probably a life’s work, some mystics

would argue many lives' work. Noticing the mistakes is a huge advantage and so rarely done. What follows are three mistakes that, in our opinion, contribute to more unhappy outcomes than most. These are: denial, that is the reinvention of reality in the mind because the truth is too painful to bear; anchoring, that is a static, historic vision of a problem; and drift, that is how small, incremental changes in thinking build into a big mistake. Add judging to the list as well, in the sense of condemning or exalting: that disposition stops a lot of rational thought, and it is almost ubiquitous. One of our favourite Buffett stories came from an interview with Walter Schloss carried in the Outstanding Investor Digest (June 23rd 1989, www.oid.com)

Walter: *“Warren (Buffett) was playing golf at Pebble Beach with Charlie Munger (Berkshire Hathaway vice-Chairman), Jack Byrne (Fireman’s Fund Chairman) and another person. One of them proposed, “Warren, if you shoot a hole-in-one on this 18 hole course, we’ll give you U\$10,000. If you don’t shoot a hole-in-one, you owe us U\$10”. Warren thought about it and said, “I’m not taking the bet.” The others said, “Why don’t you? The most you can lose is U\$10. You can make U\$10,000”. Warren replied, “If you are not disciplined in the little things, you won’t be disciplined in the big things”.”*

I have thought about this story for years, and two things strike me: first, Buffett had to think about the answer, no doubt calculating odds and price. I am always relieved that Buffett’s skills had to be learnt and honed, they were not simply innate! Second, Buffett recognised that little lapses in discipline themselves have implications: in other words, he was watching out for drift.

One trick to help see the world more clearly is to invert situations. A newspaper headline claiming that one third of the population wants something, also tells you that two-thirds don’t! In our opinion, the best book to hone the skills of inverting was written by Terry Arthur in 1975 and is entitled “95% is Crap – A plain man’s guide to British politics”. Terry is one of the most modest and thoughtful people Zak and I have had the pleasure of meeting, and he was one of the first investors in Nomad. Enclosed with this letter is a copy of the second edition of Terry’s book, updated for modern crap. Once you have read this book, we promise you will not see presented facts the same way again. For those with an interest in such things, we purchased our copies at a discounted price on Amazon. We recommend you buy a copy for everyone you love, on Amazon too, of course.

Mistakes in the Making. Myth: Say-something syndrome lowers risk

In John Rockefeller’s biography, “Titan”, Ron Chernow describes how Rockefeller equated silence with strength. In one incident Rockefeller was reported as saying that *“weak men had loose tongues and blabbed to reporters, whilst prudent businessmen kept their own counsel”*. Standard Oil’s acquisition led growth could be a problem therefore, as taciturn management could become diluted with a more loquacious, acquired intake. In one acquisition Rockefeller was therefore especially delighted to snare Charles Lockhart, a bearded Scot with a frosty manner who was, in Rockefeller’s words *“one of the most experienced, self-contained men in business”*. During negotiations to purchase his firm, Lockhart had listened attentively but hardly breathed a syllable. This elicited Rockefeller’s highest praise, *“That kind of man I’d like to have go fishing with me”*.

Taking a leaf from Lockhart's book, the question is, do Zak and I say too much? For example, it is interesting that two of the best performing funds of all time did not disclose their holdings to investors. These were the Buffett Partnership and Walter Schloss Associates, although Buffett wrote extensively about how he thought and approached investing in general. And it was for a good reason that they did not disclose their holdings, they did not wish to be judged, second-guessed or worse (!) as Walter Schloss revealed in the same interview with the Outstanding Investor Digest,

OID (interviewer): *Is it true that even your clients don't know what you're buying for them?*

Walter Schloss: *That's correct. And a little story might help explain why we don't tell them what we own. One of our partners said,*

"Walter, I have a lot of money with you. I'm nervous about what you own."

So, I made an exception and said,

"I'll tell you a few things that we own".

I mentioned the bankrupt rail bonds and couple of other things we owned. He said,

"I can't stand knowing that you own those kind of stocks. I have to withdraw from the partnership."

He died about a year later. That's one of the reasons we don't like to give people specifics."

OID: *You should not blame yourself. He might have died anyway.*

(Then again, he might not!) Let's invert for a moment: when we think of our investee companies, the firms which we would quite happily own with no word from them for years are those businesses in which we have the highest confidence of reaching a favourable destination: they are the firms we think we know will work. They are also the largest holdings in Nomad. It is the less certain businesses about which we are more insecure that appear to demand more regular attention. If there is demand for our holdings list, is that what our clients are sub-consciously asking? A bit of handholding please because the trust is lacking? And what does that say of the monthly reporting that passes for industry norm? Thank you for helping us avoid that mistake. Our six-monthly writing may be as irrational as monthly reporting, but at what frequency does letter writing become rational? Presumably when one has something meaningful to say. Gosh, that is not very often! A Charles Lockhart disposition would argue for an ad hoc, rather than diarised, schedule to letter writing. Perhaps this is something to pursue in the future.

In previous letters we have discussed the dysfunctionality of disclosing specific investment ideas. The problems are mainly psychological and include the locking in of an idea, the desire to seem consistent, the wish to seem prudent in other people's eyes and so forth. There is then the effect of copy-cat investing, brokers trading against us and, as Walter Schloss found out, dealing with nervous-Nellies and so on. In this letter we have expanded on the topic somewhat.

It is tempting to see the free distribution of our holdings list as an unforced and unnecessary mistake, and so one course of action would be to stop sending them out. However, if we did stop that would also presume that the list was only used for the worst (and I have gone on about being judgmental in this letter already!). We know that some partners have a natural healthy curiosity to see how their money is being invested (if the tables were turned, we would too!) and Zak and I have learnt a great deal from reverse engineering others' holdings, and so we will continue to disclose our holdings, although under separate post.

We ask you to examine your motivation for studying our holdings list. If, for example, you think you are monitoring investment risk in monitoring the share prices of investee firms, then perhaps Nomad is not for you. In our opinion, transient, historic, stock price quotation volatility is not the same as investment risk. Indeed, quite the opposite. If, however, you study our holdings through a joy for the art of investing, our books are open to you (well, with a lag).

Investors will understand that the further distribution of our ideas is contrary to all partners' interests. As ever, our preference is that the holdings list remains private and we remind you that the contents of these letters are not to be reproduced without permission. We do hope you understand.

We focus on what we control

The following excerpt is taken from Reverend Norman O'Neal's account of the life of Saint Ignatius Loyola. Prior to conversion, Ignatius had been a soldier in the Spanish army and was injured in a battle with the French.

“During the long weeks of his [Ignatius'] recuperation, he was extremely bored and asked for some romance novels to pass the time. Luckily there were none in the castle of Loyola, but there was a copy of the life of Christ and a book on the saints. Desperate, Ignatius began to read them. The more he read, the more he considered the exploits of the saints worth imitating. However, at the same time, he continued to have daydreams of fame and glory, along with fantasies of winning the love of a certain noble lady of the court. The identity of this lady has never been discovered but she seems to have been of royal blood. He noticed, however, that after reading and thinking of the saints and Christ he was at peace and satisfied. Yet when he finished his long daydreams of his noble lady, he would feel restless and unsatisfied.”

Poor Ignatius. One can see how he is credited, by some, with the following prayer:

*“Give me the strength to accept that which I cannot change, The
courage to change that which I can,
And the wisdom to tell the difference.”*

It is a very beautiful statement and is helpful in thinking about the Partnership. In our opinion, the biggest risk in investing is the risk of misanalysis. We seek to control this risk through the quality of our research, especially through applying what we have learnt. The quality of our research-based decisions overwhelmingly determines whether we will do well in the long run. But it has almost no influence over the timing of these results. Zak and I do not control the annual performance figures. It might be nice if we did. But we don't.

We encourage you to focus on what we control too!

To our partners great credit we have never had hand-holding requests and, with the exception of a friend of mine who studies share price charts rather than companies and shall therefore remain nameless, no redemptions. It would be wonderful if this was because our partners have a stoic indifference to short term results. And better still if this was because partners read our letters, know the philosophy and methodology of what we do, and know that this is the engine

of future success.

Our aim is have the same relationship with partners during periods of poor performance as we do during the good times. And we aim to do this through encouraging our partners to focus on the things we control. That is quite a goal, and we understand that what we are asking goes against human nature. My father worked as a geologist for the Abu Dhabi Oil Company in the early 1960s, and the unofficial motto amongst the engineers there was “*aim high and grab what you can as you fall*”. It is in the spirit of aiming high that we ask you to focus on inputs rather than outputs. It is the rational thing to do. If we were all focused on what can be controlled then that would be something special!

A trick to help the rational mind is to put our periods of good performance together with our poor performance. We encourage you to mentally shuffle the surplus from the good years and allocate it to the deficit of the bad years. Especially any future bad years, please! Better still, take away the adjectives used to describe the years. That way one can accept life as it is. After all, regardless of the order in which annual results fall, the destination will be just the same.

Housekeeping

Northern Trust has been appointed as custodian bank, the transition from the incumbent operative took place in November and it all went without a hitch. This completes the transition started two years ago with the replacement of the incumbent administrator (the same provider) by the excellent folks at Phoenix Financial Services (do call Phoenix +353 1 845 8161 with your statement enquiries). Hopefully there should be little contact with Northern Trust, however, should the need arise, do call Marcia Denham on +44 207 982 2213.

Nomad means far more to us than simply managing a fund. As a younger man I separated investing from the rest of my life, as if they were different worlds. This is a false construct. Another mistake. What we learn from home-life helps us be better investors, and what we learn as investors helps us be better husbands and fathers. In the end, all reality has to respect all other reality.

Nomad is a rational, metaphysical, almost spiritual journey (without the sand and camels, although Zak may be happier with them). And that’s what a full life is all about. Thank you for your support.

Yours sincerely

Nicholas Sleep

* Sleep, Zakaria and Company, Ltd., 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 this transition 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, Ltd., means that the Partnership does not benefit from the same back office infrastructure support it 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.

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Appendix

Dear

Thank you for your letter informing us of your concerns with conditions in the Sudan and linking this to any investments Nomad may have. Zak and I agree that conditions in Darfur are appalling and we sympathise with the desire to do something about it.

As Nomad has no investments among the list of companies provided, it would be easy for us to just leave it at that. (Phew!) However, the logic of the proposition raised an eyebrow or two here, and there are some interesting principles at foot, so may I elaborate?

We do not necessarily divest our shares in companies because we disagree with a particular activity of that company. Heaven forbid – there would be nothing left to invest in! I am sure that as I write this someone, somewhere in an investee business is doing something Zak and I would very much regret, and we live with that reality.

Even if we did choose to take exception to a company's activity, would divesting our shares work? In our experience being inside a company is far more likely to influence behaviour than being outside. After all, shares come with votes! Indeed, if all those that agreed with the

proposal sold their shares to those that disagreed, would that not risk entrenching the activities of the company? It seems to us that an open debate both inside and outside a firm has a greater hope of influence than a scenario where management can hide in the boardroom protected by their shareholders' support.

Nomad is a pooled fund (not a bespoke, segregated fund) and, if we did divest an otherwise sound investment, perhaps at a price depressed by others pursuing the proposed strategy, we may be rightly criticised by other Nomad investors for placing the proposer's interests above their own. That is not a conversation I would relish! Let's invert the situation: how would the proposer feel if another investor in Nomad proposed to divest a series of companies on the grounds of an issue they did not feel strongly about?

I am sure some investors in Nomad have different views to our own on, say, tobacco, alcohol and arms (all permissible) and we all get along quite well under the general mandate to grow capital over the long term. Of course, how investors then choose to spend their profits from investing in Nomad is up to them.

Whilst the motivation is understandable, the consequences of the proposal, and the consequences of the consequences (the "what thens" of the situation) may not be what was wished for.

So to be clear, Zak and I disagree with the rational logic of the proposal, and we would consider making an investment in, say, Rolls Royce, if we came in tomorrow and the share price was £1.

Indeed, we should all be so lucky!

With all best wishes

Yours sincerely

Nicholas Sleep