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Nomad Investment Partnership

Interim Letter

For the period ended June 30th, 2009

To June 30 th , 2009	<u>Nomad Investment Partnership</u> *	<u>MSCI World Index (net) US\$</u>
Trailing:		
Year to date	+20.9%	+6.4
One year	-16.5	-29.5
Two years	-31.7	-37.0
Three years	-11.5	-22.2
Four years	-2.5	-9.0
Five years	+23.1	+0.2
Six years	+73.6	+24.2
Seven years	+113.5	+21.2
Since inception (Sept 10 th 2001)	+144.8	+14.6
Annualized since inception:		
Before performance fees	+12.1%	+1.8%
After performance fees including performance fees reimbursed	+9.6	

The figures above are unaudited, presented on a cumulative basis and, as ever, are 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 June 30 th , 2009:	<u>Nomad Investment Partnership</u>	<u>MSCI World Index (net) US\$</u>
Calendar Year Results:		
2009 (year to date)	+20.9%	+6.4%
2008	-45.3	-40.7
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	+10.1	+3.6

“This Abstract, which I now publish, must necessarily be imperfect. I cannot here give references and authorities for my several statements; and I must trust to the reader reposing some confidence in my accuracy. No doubt errors will have crept in, though I hope I have always been cautious in trusting to good authorities alone. I can here give only the general conclusions at which I have arrived, with a few facts in illustration, but which, I hope, in most cases will suffice. No one can feel more sensible than I do of the necessity of hereafter publishing in detail all the facts, with references, on which my conclusions have been grounded; and I hope in a future work to do this. For I am well aware that scarcely a single point is discussed in this volume on which facts cannot be adduced, often apparently leading to conclusions directly opposite to those at which I have arrived. A fair result can be obtained only by fully stating and balancing the facts and arguments on both sides of each question; and this cannot possibly be here done.”

So begins paragraph three of “On the Origin of Species by Means of Natural Selection” by Charles Darwin, the bicentenary of whose birth falls this year. The book took Darwin twenty years to write and may have done more than any, with the exception of the Bible, to shape man’s self-perception. But just look, if you will, at the language of the introduction:

“This Abstract must necessarily be imperfect...no doubt errors have crept in... I can here only give the general conclusions...I am well aware that scarcely a single point is discussed on which facts cannot be adduced, often apparently leading to conclusions directly opposite to those at which I have arrived...A fair result can only be obtained by fully stating and balancing the facts on both sides”.

One can hardly accuse the man of promotion! Darwin knew he was right but his findings troubled him personally. He was a Christian, in a Christian society, indeed he had considered studying theology before setting sail on HMS Beagle, and his new ideas challenged the church, his countrymen and his conscience. At major turning points in society, such as he was suggesting, how many of us, we wonder, would be modest about what we had discovered? Darwin’s humility is an attractive human quality, perhaps because such understatement recognizes that the ideas were bigger than the man. Which, of course, they were. It is an interesting subconscious psychological tendency that truths are often spoken with a whispered voice whilst shaky suppositions are shouted for all to hear. It is not so much us that the shouters are convincing, as the need to convince themselves. We all shout to some extent, with agents usually shouting louder than principals: and that should tell us something. In the Nomad ecosystem we do try to keep the volume down somewhat. Like Darwin, perhaps, but on a very different scale, we recognize a few simple truths and we are conscious that our views, in the eyes of our peers, may not be very popular.

Empty Vessels and a Quieter Approach.

Upon reflection, it is curious that this quiet attitude extends, in its own way, to the companies in which we have entrusted your dollars: Amazon and Costco do not advertise (no shouting here); Berkshire Hathaway and Games Workshop do not provide earnings guidance (popular with baying fund managers and stockbrokers); Amazon, Costco, AirAsia, Carpetright, and parts of Berkshire give back margin to the customer, we would argue that is a pretty humble strategy too. In other words, around two thirds of the portfolio is invested in firms that in some major way shun commonplace promotional activity and they are no less successful as a result.

If one steps outside of stock market listed companies to instead observe private firms run by proprietors and founders, it is the quiet approach that is far closer to the norm. Let's invert: why are publicly listed companies so promotional about their affairs? Are these companies shouting to inform shareholders and customers or convince themselves?

Nomad's investments may be in publicly listed firms but these firms are also overwhelmingly run by proprietors who think and behave as if they ran private firms. Amazon for example struggles with institutional investor relations so much so that the good people that man the IR department do so knowing that the firm's founder, Jeff Bezos, thinks their role is all but a waste of time! Poor souls. Bezos was also quite forthright on the subject of product promotion and advertising at this year's annual general meeting:

“Advertising is the price you pay for having an unremarkable product or service”.

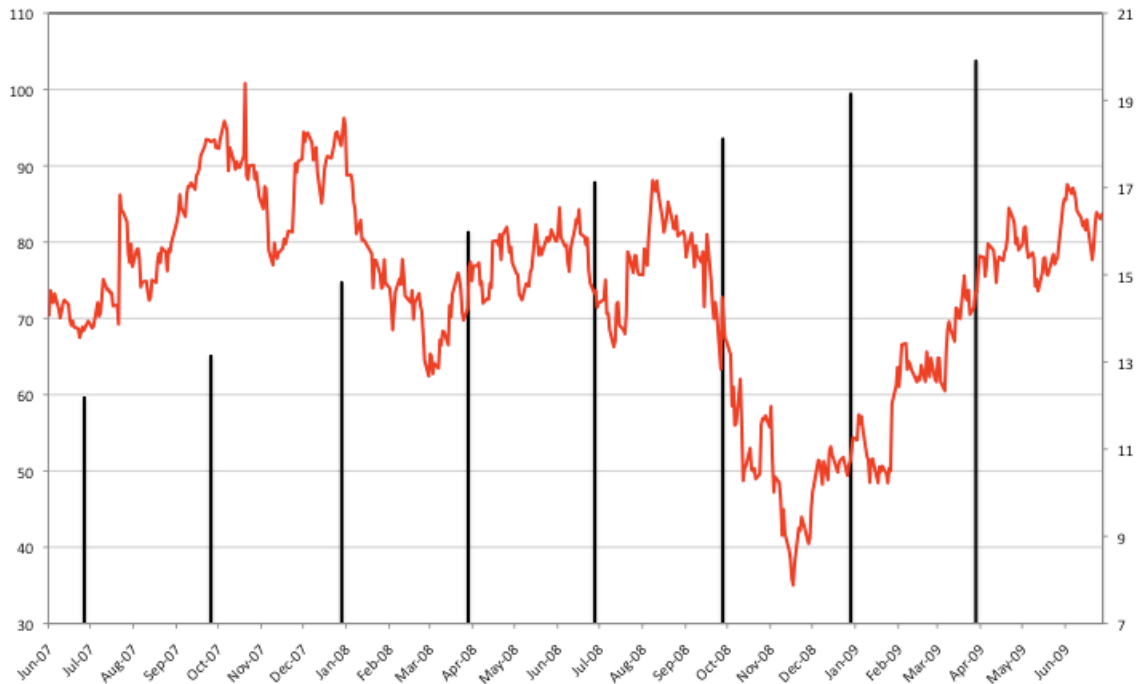
It is interesting to note that the other end of the promotional scale is exemplified by the pop star razzle of General Motors which had the largest advertising budget of any company whose annual report we read this year (actually that title went to GM last year, and the year before, and the year before...). The advertising spend was U\$5.3bn in 2008, or U\$630 per car delivered. It is fun to muse that had the company made cars that required little advertising support, then the firm's last five-years' advertising spend may have been sufficient to retire half of the company's debt, at par, instead! But, it seems, it was easier to call Madison Avenue than build cars that sold themselves. In our opinion, GM is very much the empty vessel making the most noise, in this regard. Our portfolio takes a different path. The whispered voice of price givebacks is economically fruitful but only if the customer reciprocates in the form of more spending, even in the face of more promotional approaches by competitors. For evidence that this is the case with our whisperers look no further than the average revenue growth rate of the largest investments in Nomad (including some of the companies mentioned above, err, not GM!) which, in the most recent reporting period, was in excess of ten percent!

Why? In a word, price. It is in times like these that the hyper-efficient low-cost providers, who share the benefits with their customers, often take permanent market share. This fact rather reminded us of a quip by Wal-Mart founder, Sam Walton, who, when asked about the recession of the early 1990s, stated:

“I've thought about it and decided not to participate”.

Amazon, for example, is choosing “*not to participate*” in as much as trailing twelve-month revenues have risen by over sixty percent since the onset of the credit crisis, say mid 2007. Not that the steady growth in revenues has always been apparent in its stock price, as the chart below describes. As a youthful analyst I used to have a notice on my desk that read, “*share prices are more volatile than corporate cash flow, which is more volatile than asset replacement cost*”. It was reminder to concentrate on non-transitory items. Today I would update such a notice to read, “*share prices are more volatile than business values*”, but the gist is the same: a reminder to focus on lasting value, not transitory prices. More on this subject later in this letter.

Chart 1: Make up your mind, U\$100 or U\$40? Amazon.com trailing twelve month revenues (in billions of dollars, rhs) and share price (lhs).



Source: Company accounts, Bloomberg, Sleep, Zakaria and Company, Ltd.

The Investment Industry and Over-Diversification, again.

In business, thoughtful whispering works, which makes it all the more remarkable that the investment industry, as well as many economic commentators, spend so much time shouting. So much commentary espouses certainty on a multitude of issues, and so little of what is said is, at least in our opinion, knowable. The absolute certainty in the voice of the proponent so often seeks to mask the weakness of the argument. If Zak and I spot this, we metaphorically tune out. In our opinion, just a few big things in life are knowable. And it is because just a few things are knowable that Nomad has just a few investments.

The church of diversification, in whose pews the professional fund management industry sits, proposes many holdings. They do this not because managers have so many insights, but so few! Diversity, in this context, is seen as insurance against any one idea being wrong. Like Darwin, we find ourselves disagreeing with the theocracy. We would propose that if knowledge is a source of value added, and few things can be known for sure, then it logically follows that owning more stocks does not lower risk but raises it! Real diversification is offered by index funds at a fraction of the price of active management.

Sam Walton did not make his money through diversifying his holdings. Nor did Gates, Carnegie, McMurtry, Rockefeller, Slim, Li Ka-shing or Buffett. Great businesses are not built that way. Indeed, the portfolios of these men were, more or less, one hundred percent in one company and they did not consider it risky! Suggest that to your average mutual fund manager. And it is interesting to note that none of the great fund management organizations got rich on the back of the most successful companies of the modern era either!

This failure goes largely unrecognized, and certainly ignored, perhaps because it is the elephant in the room. (Quick, change the subject). It is ignored because some fund managers are not trying to make clients rich per se, but instead their goal is to beat their peers or a benchmark. Fine, but what strikes us about such a disposition is that, somewhere in that frame of mind, one ceases to be an investor and starts to be a business manager and, to borrow a phrase from a popular UK TV advert, “*that’s not what is says on the tin*”. When investment skills share a seat with business management, in time, it’s the commercial genes that tend to thrive, and investment skills that are not used end up atrophying. Is that why the fund management industry finds itself, like GM, relying so heavily on marketing?

Back to real investing! The trick, it seems to us, if one is to be a successful long-term investor, is to recognize the sources of enduring business success, get in early and own enough to make a difference. Which raises two questions: what are the sources of success and second, if these are so readily recognized up front why are they not discounted in prices already? We will spend the balance of this letter answering these two questions.

Seeing, but not Understanding.

How might corporate success be predictable? There are some clues in the world around us. Zak and I observe several business models that work in the long run, and scale economics shared is one of these, witness Ryanair, Wal-Mart, Geico, Southeast Airlines, Tesco, Nebraska Furniture Mart, Direct Line et al. And that is why companies that share scale with the customer such as Carpetright, Costco, Berkshire Hathaway, Amazon and AirAsia make up around sixty percent of the Partnership. It works because it turns size, normally an anchor to growth and returns, into an asset. But I also don’t think this is a great secret.

Investors are broadly rational people (they all knew that Wal-Mart was a wonderful business) and fund managers operate under healthy profit incentives that ought to foster good outcomes, so why is it that no one but the founding Walton family-owned Wal-Mart all the way through? Zak and I were told a story by one of the industry’s most senior fund managers which we enjoyed enormously and might help illustrate the point. In the early 1970s a then, and still today, large successful fund management company analysed its portfolio and discovered that their sale of IBM thirty years earlier had been a huge error of omission. If they had instead kept their IBM shares for the last thirty years, that stake alone would have been larger than total funds under management. No doubt they all agreed to learn from that particular mistake and, as so often happens, went back to their desks and got on with life as before, as if nothing had happened. It is fun to note that, at about the same time, they also made the decision to sell their stake in Wal-Mart, which, thirty years later, would be worth more than their then-to-be funds under management! In terms of dollars of opportunity lost, it is likely to be the biggest single error this firm will make.

We offer the following reasons for this mistake:

1. Misanalysis, or using the wrong mental model: Investors are used to firms which have one good idea, such as a new product, but then struggle to replicate success and end up diluting returns (Zak and I call this the Barbie problem, as Mattel has struggled to replicate the economics of its famous doll). Taking this model and applying it to Wal-Mart would miss the company’s source of success entirely as the strategy of price givebacks did not change from year to year; culture plays a part in the continuity of a successful price giveback strategy and factors such as culture, because they are hard to quantify, often go undervalued by

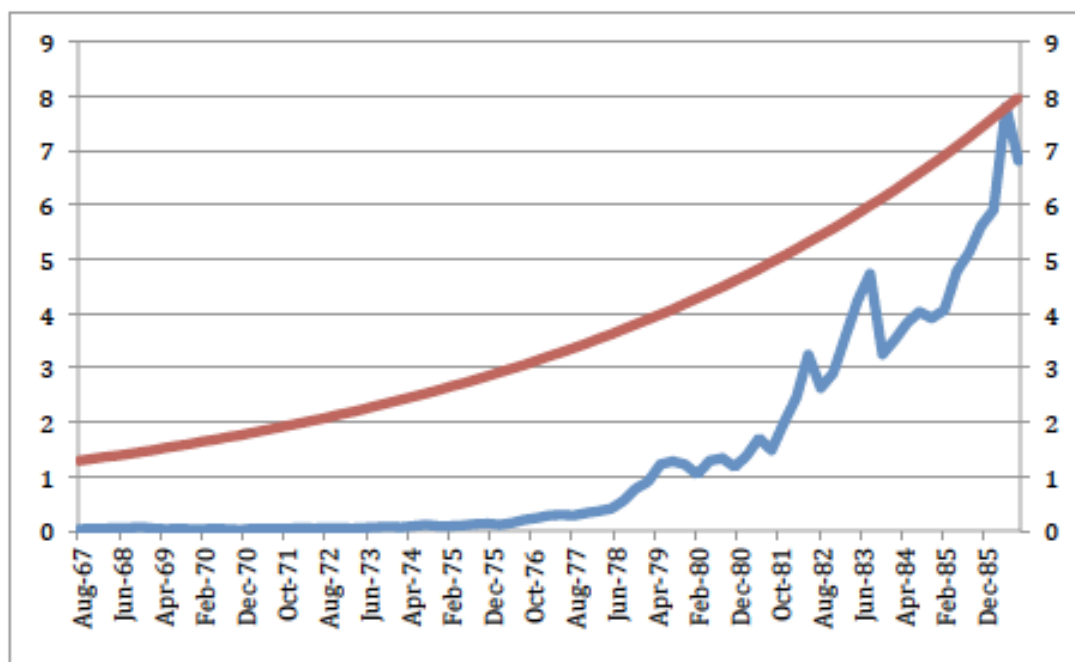
investors; investors presume regression to the mean starts at the time of their analysis or, as CFA students may recognize, in year three or five of a DCF analysis! Investors use valuation heuristics rather than assess the real value of the business.

2. Structural or behavioral: Active fund managers have to look active. One way to do this is to sell Wal-Mart, which appeared expensive (but actually wasn't), to buy something that appeared cheaper (but err, also wasn't); investors are not long-term and did not look further than the next few years or, more recently, few quarters. Evidence for this can be gleaned from the average holding periods for shares which stands at just a few months; fund managers wish to keep their jobs and espousing a ten-year view on a firm risks being a hostage to fortune; marketing folks require new stories to tell and new stocks in the portfolio provide new stories; fund managers sell their winners in order to appear diversified in the eyes of their clients.
3. Odds or incorrectly weighing the bet: In the words of my first boss, investors tend not to believe in "*longevity of compound*". Conventional thinking has it that good things do not last, and indeed, on average that's right! Empirical Research Partners, an investment research boutique, discovered that the chance of a growth stock keeping its status as a growth stock for five years is one in five, and for ten years just one in ten. On average, companies fail.

The list above is far from exhaustive and we can all pick our favorites. No doubt some combination of these, plus others, acted in the minds of sellers. It matters not particularly. What matters is the effect of this collective mis-cognition. Investors know that in time average companies fail, and so stocks are discounted for that risk.

However, this discount is applied to all stocks even those that, in the end, do not fail. The shares of great companies can therefore be cheap, in some cases, for decades. To illustrate the point, consider the graph below. The blue line represents the share price of Wal-Mart and the red line the price that one could have paid at any time since 1972 (the firm's initial public offering) and then earned a return of ten percent (a proxy for a reasonable equity return) through to today. The red line can be thought of as what the firm was really worth.

Chart 2: Cheap for Decades. Share price of Wal-Mart (blue) and the price one could have paid and still earned a ten percent return (red).



Source: Company accounts, Bloomberg, Sleep, Zakaria and Company, Ltd.

Just look how long the undervaluation persisted! If, in 1972, upon reading that year’s twelve page annual report (!) an investor chose to make a purchase of shares, he could have paid over one hundred and fifty times the prevailing share price (a price to earnings ratio of over fifteen-hundred times, a ratio far in excess of what professional fund managers would consider prudent. They would be mistaken, as it turns out) and he would have still earned a ten percent return on his investment through to today. If, instead, the investor thought about it for a while and decided to purchase shares ten years later he could still have paid over two hundred times earnings for his shares (beware heuristics) and still earned ten percent on his investment. And ten years after that could also have paid a premium over the prevailing Wal-Mart share price and done well subsequently. The market struggled to appreciate the magnitude and longevity of the business’ success. But why?

Weighting the Information

Investors see the information (on conference calls they cheer “*great quarter, Wal-Mart*”) but, in our opinion, they incorrectly weigh the information. It could be argued that lots of things had to go right for Wal-Mart to grow for forty years. That is certainly true but, at its heart, a very few simple things really mattered. In our opinion, the central engine of success at Wal-Mart was a thrift orientation fueling growth with the savings shared with the customer. The culture of the firm celebrated this orientation and reinforced the good behaviour. This is the deep reality of the business. This should have had the greatest weighting in the minds of long-term investors even if other things looked more important at the time. Instead, investors may place too much emphasis on valuation heuristics, or margin trends, or incremental growth

rates in revenues or any of the list above, but these items are transitory and anecdotal in nature.

There are very few business models where growth begets growth. Scale economics turns size into an asset. Companies that follow this path are at a huge advantage compared to those, for example, that suffer from Barbie syndrome. Put simply: average companies do not do scale economics shared. Average companies do not have a healthy culture. After all, average companies are more like GM than Wal-Mart! The removal of a portion of failure risk from the investment equation creates a huge opportunity for those investors that can see the company in its true perspective and act with a bit of patience. It is a huge anomaly that investors recognize success incrementally when the factors that lead to success, such as scale economics shared reinforced by a strong culture, may be constant. If the early investors in Wal-Mart had understood this, they may have retained their holding along with the, now billionaire, Walton family.

The fund management industry has it that owning shares for a long time is futile as the future is unknowable and what is known is discounted. We respectfully disagree. Indeed, the evidence may suggest that investors rarely appropriately value truly great companies. We can hear the howls of derision from the professional cynics “that’s twenty-twenty hindsight, guys!” Dare we whisper it but, in some cases, we think that greatness may be knowable in, shhh, FORSIGHT! This “*longevity of compound*” opportunity exists precisely because the average fund manager is attending a different church. Thank God!

Simple, but not Easy

When Zak and I trawled through the detritus of the stock market these last eighteen months (around a thousand annual reports read and three hundred companies interviewed) we had four main choices: add to existing holdings, invest in new firms, invest in growth businesses, invest in cigar butts. Overwhelmingly we have preferred our existing businesses to the alternatives. Of course, such a conclusion will only make sense if the businesses in which we have invested have great prospects and the shares are cheap. Like Darwin, perhaps, we are well aware that we live in an ambiguous world. And we are not saying, for example, that Amazon is the next Wal-Mart. Time will tell on this front. But we are asking the question, what if? The portfolio weightings are sizeable in the firms we consider to be the pick of the bunch, and Nomad should do well if our firms grow from acorns to oaks. It is this rational will to believe and be patient that perhaps marks Nomad out from its peers.

What we are doing is investing at its most honest and most simple. But it is not easy. It is hard because one first has to reject industry dogma. The non-thought of received wisdom is shouted from the rooftops and it is safe and comfortable, glamorous, exciting even, being part of the crowd. The road less travelled is hard as there is lots of heavy lifting involved in the homework, although we happen to rather like the workout. As Darwin found, it is hard to let the facts speak for themselves, reject the established way of thinking and to do so in good conscience. And it is a blessing for us that the crowd have rejected something so obviously right as investing at its simplest. Phew, that was just as well! Indeed, such is the lure of, what might be called, professional fund management techniques (!) that we find there is, albeit with a few notable exceptions, almost no competition for the long-term investor who has done his homework. Isn’t it exciting that honest, simple, long-term investing is so, well, un-exciting.

The State of our Partnership

Some facts and figures may help paint a useful aggregate picture of the Partnership. Zak and I think of the Partnership in terms of business models deployed by our investee firms. The names we use to describe these models are not that catchy but please bear with us. The largest group making up over half the Partnership are, no drum roll required, scale-economics-shared; next comes discounts-to-replacement- cost-with-pricing-power (I warned you) at around fifteen percent; hated-agencies fifteen percent; super-high-quality-thinkers just under ten percent. The Partnership has twenty investments but a noticeable concentration in ten, which make up around eighty percent of the portfolio, and for those with sharp eyes around thirty percent of the Partnership in one investment. Although the bulk of the Partnership is listed in the United States, look-through revenues are far more diversified: US dollar revenues forty-seven percent, Euro and Swiss Franc revenues twenty-one percent, South East Asian currencies sixteen percent, Sterling ten percent, Yen three percent and others three percent. There are perhaps six main industry groups and their weightings are as follows: internet thirty percent, consumer staples sixteen percent, consumer discretionary fourteen, business services thirteen, insurance and finance eleven, and airlines eight percent, with a tail of smaller groupings.

Return on capital in the portfolio is extremely high, as are endemic growth rates. We estimate that around three-quarters of the portfolio is invested in growth businesses, which have the potential to compound for many years, and the balance in more cigar butt like investments (we just could not help it!). In aggregate the portfolio is priced in the market at meaningfully less than half our appraisal of what our firms are really worth. The Partnership will remain open to incremental subscriptions whilst this is the case. Here ends the marketing pitch from the chief marketing officer, who now announces his retirement!

One common psychological trap that agents may fall into is that clients expect action, or to be more accurate, fund managers expect their clients to expect action! The investor Seth Klarman was once challenged on whether Buffett's track record was statistically significant as he traded so little? To which Klarman answered that each day Buffett chose not to do anything was a decision taken too. It is quite possible that we may not change the companies in which we have invested very much over the next few years. Indeed, that is our preference. Zak and I expect that we have built a portfolio not just for the recovery out of recession but for many years after that too. At least, we aim for such a Zen-like state.

Housekeeping

Our cost reimbursement management fees are running at around twenty basis points per annum. We could get it lower, but not by much, and would rather let it fall naturally as the fund grows in size. It is a fair estimate that, if Nomad was a billion dollars in size, the management fee would halve in basis point terms. We target single digit basis points in time. The reimbursable performance fee was, indeed, reimbursed to investors last year. And so it should be.

Thank You

It is with the greatest delight, and respect, that we report that Nomad has had net subscriptions as a result of the credit crisis. I think that is a fact of which we can all be proud. And we have had nothing but notes of support during a period when the market, and gyrations in Nomad's share price, could have given much cause for concern. That ecosystem is special. Thank you.

As always, we thank you for your confidence and most especially your patience. Back to those annual reports.

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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