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## Nomad Investment Partnership

### Annual Letter For the period ended December 31st, 2008

To December 31st, 2008	<u>Nomad Investment Partnership</u> *	<u>MSCI World Index (net) US\$</u>
Trailing:		
One year	-45.3%	-40.7%
Two years	-33.7	-35.4
Three years	-24.7	-22.4
Four years	-17.8	-15.0
Five years	+0.4	-2.5
Six years	+80.3	+29.8
Seven years	+82.7	+3.9
Since inception (Sept 10 <sup>th</sup> 2001)	+101.1	+7.7
Annualized since inception		
Before performance fees	+10.1	
After performance fees	+7.1	+1.0

The figures above are unaudited, presented on a cumulative basis and are before fees, most notably, performance fees. As usual we quote performance before fee payments as Nomad's time dependent hurdle means that investors with different purchase dates will also have different net-of-all fees experiences. Below the same pre-fee 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, 2008:	<u>Nomad Investment Partnership</u>	<u>MSCI World Index (net) US\$</u>
Calendar Year Results:		
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 (inception Sept 10 <sup>th</sup> 2001)	+10.1	+3.6

## Thinking about Inputs: The Price to Value Ratio

It is quite something to arrive at the end of a five-year period and for Nomad's returns to be all but zero, and precious little better than the index to boot. This is a very interesting statistic. All that work and effort! Quite what are we doing with our lives, and with other people's money? Please don't answer that just yet! One could compare market trough to market trough, broadly equivalent to our performance since inception (suspend judgement if you will and call today a trough) in which case returns are in the order of 10% per annum, and 9% per annum superior at Nomad compared to the average share or broadly a doubling in Nomad's share price whilst the index did nothing. That is more like it. And it could be argued that, since inception the price to value ratio of the partnership has been meaningfully lowered, implying healthy deferred returns to come. Even so, bear markets are tough and make you test the most basic assumptions. When moments like these arise grace under pressure all-round is the order of the day.

The following excerpt is taken from the June 2005 Nomad letter to Partners:

*“Zak and I concentrate on the price to value ratio of the Partnership and ignore its performance as much as is practical, and we would encourage you to do the same. In our opinion you should be more pleased with the improvement in the price to value ratio of the Partnership than the gain in the price of the Partnership this year. That's easy to say when results have been reasonable. But it would feel quite different if the Partnership had declined in price instead. Unfortunately nature does not always help us to think rationally. Psychologists (McClure, Laibson, Loewenstein and Cohen 2004) have found that the brain perceives immediate rewards differently to deferred rewards because two different parts of the brain are involved. Immediate gains are perceived positively compared to larger deferred gains as the limbic (survival) system has the ability to over-ride the fronto-parietal (analytical) system. Interestingly, stress induces this over-ride, and of course, money induces stress. So, the more stressed we are, the more we value short-term outcomes! This is not without reason, for if starving is a real possibility, a meal today is more important than a feast in a week's time, and the brain's wiring reflects that survival bias. Such notions are embedded in popular phrases such as “a bird in the hand is worth two in the bush”. But at Nomad we try to be more analytical: it is the two birds in the bush we are concerned with and how they compare to the bird in the hand...It is price to value that's important.”*

Whether business values rise faster than share prices, or share prices fall faster than business values, either way the effect is the same: a growing differential between the price of a business in the stock market and its real value. It does indeed “*feel different*” when performance has been as poor as it was in 2008, but the rational mind will anchor on the notion that today the birds in the bush are very large indeed. It may not feel like it but, in many respects, these are the best of times for an investor, and we shall lay out why in this letter. The reason opportunity abounds and there are so few takers (indeed the two are necessary bedfellows) is the headline to every newspaper, leads every news channel, is on the lips of every politician and we have all been subjected to so much economic prognostication that we will spare you its repetition here. Crises such as these do not reveal mankind at its best, far too much limbic thinking for our liking, and the sooner we can learn and move on the better. It does not feel like it, but crises like these are a force for good, and we will discuss this point too later in this letter. First, what can we learn?

## Using up the Safety Net

One of the things this crisis reveals, at least in our opinion, is that there has been little give-in-the-system: that is to say, a lack of slack. Slack in time to think things through, or capital for investment for example. In a recent interview the author Nassim Taleb put it succinctly: “*Capitalism does not teach slack, it teaches optimisation*”. That is capitalism teaches that assets must be worked hard, outputs maximised, returns as high as can be. We all see so much of this line of thinking that it has become part of the landscape so familiar as to not be noticed any more. Itineraries must be filled with meetings, school children’s days must be filled with activities (I know my daughters’ are), borrowing capacity must be used (or risk an “inefficient capital structure” – we have never really understood what that is), investors answer emails instead of listening to presentations, holidays are to be taken with Blackberries rather than books, or nothing: outputs must be maximised today! And for most of the decade, there has been nothing as sinful in an investor’s mind as money idly slouching on deposit, “*on the couch*” as the investor Seth Klarman put it. Instead, cash must be put to work: its yield maximised. Indeed, and in the parlance of bond investors, “*chasing yield*” has been one of the maxims of the noughties.

Output maximisation looks efficient at least in the short term, but that is not the same as being long term optimal. The flaw to putting money to work immediately, for instance, is to presume that all relevant opportunity sets are available immediately. By accepting, say, a promoter’s promise of eight percent returns (six hundred basis points better than money on deposit), the investor denies himself the right to future opportunity sets which may be far better, like public equity circa 2008 and 2009, we would argue. This is an easy concept to grasp when applied in hindsight, but much harder to see prospectively. A plan sponsor who argued that contrary to the income statement, his cash was not earning two percent but ten percent (a blend of two percent on deposit now and twelve percent from an as yet undefined opportunity set sometime in the future) risks being perceived by his peers as away with the fairies – the lawyers and auditors would not endorse his view - but he was right. That is why, in the hands of Warren Buffett for example, one could rationally argue that cash is worth more than cash. That is not an argument for hoarding cash, as many do today. For the cash to be worth more than cash it must be invested intelligently. It is, however, an argument for a cash buffer, just in case, a little slack in the system.

Charlie Munger, Berkshire Hathaway Vice-Chairman, was once asked how to get rich, presumably by someone of youth and modest means. Being of relatively modest means if not youthful ourselves Zak and I were keen to hear the answer: “*wait for an opportunity and invest the spare million dollars you have lying around*”. What Charlie was telling us was that slack cash is worth more than cash. It was not what we wanted to hear. Now all we had to do was come up with a million dollars of slack cash!

A little slack would also have avoided fifty-to-one gearing ratios at the investment banks, burnt out school children, wasted holidays, and nothing-learnt business meetings. “*When someone says he is busy, he means that he is incompetent*”, Nassim Taleb again, “*having a stupidly busy schedule isn’t a sign of being important. It means that you have become insulated from the world*”. And we wonder, if you are too “*stupidly busy*” to think, which part of the brain is making the decisions? Not the rational outer cortex, we suspect. All this busy behaviour looks short term efficient (ten meetings a day!) but, in our opinion, the cost is that things are not being thought through; the end result of a thousand small steps in the current direction not assessed and long-term bad habits creep in. The biggest mistakes are the ones

that did not look like mistakes at the beginning, after all bank robbers don't start out robbing banks, they pinch sweets, get away with it, and drift their way up. I suspect many robbers' behaviour later in life would be inconceivable to them when they started. We all drift to some extent. Notice, for example, how company spokesmen use words. To hide reality, the embarrassed use acceptable words to replace accurate words. This is how companies end up talking about "*negative growth*" rather than declines, and how bank investor relations spokespeople talk of "*market turbulence*", when what they are referring to, we would suggest, is their own bad lending. If businesspeople are too busy to notice that their use of everyday language has drifted into, let's face it, low level lying, how were they to be honest enough with themselves to recognise the inevitable asymmetry embedded in securitised mortgages? All they were doing was making the next loan and selling it: No assessment of the destination of such behaviour required.

The thinking – or non-thinking – was contagious, and if it was good enough for bank X then it must be good enough for bank Y, and both companies reinforced these attitudes through quarterly reporting and annual incentives. The point is that the drift toward poor long-term outcomes is so much harder to spot if your reference periods are short, and one is too busy being busy to notice a lack of real world thinking. Many publicly listed bank executives are certainly subject to these two factors. Is it any wonder these firms are at the epicentre of the financial crisis?

All this is a far cry from the early years of Rolls-Royce Limited, the manufacturer of motor cars, where Frederick "Henry" Royce made the engineers personally sign the parts they were responsible for making. That way, if any component proved faulty, he knew who was responsible and he made them correct the fault in their own, unpaid time – *I paid you to make a working part, not a faulty part*, he would argue. And that is how he ended up making the best motorcars in the world. That level of personal accountability has been largely lost inside organisations today and has instead been replaced with "*efficiency*" to the point of Taleb's "*busy incompetence*" and "*real world isolation*". Zak and I do not see the ethics behind securitisation trusts, for example, building the reputation of any bank the way that Henry Royce's engineers built the reputation of Rolls-Royce, the manufacturer of the world's finest cars. What passes for industry standard best practice today may look short term efficient but, in any lasting sense of the word, and from the perspective of the long-term business owner, it does not really get the job done.

### The Case for Slack

We do try and run Nomad with some slack in the system. In the June 2007 letter to partners we suggested that one of the benefits of a long holding period was that it allowed time for gentle contemplation, to "*retreat and simmer*" a little, and we quoted the gardener Charles Jencks: "*understanding requires a certain slowing of time. Why else enter a garden?*" Notice, "*slowing*", it is important. Slack is provided in our company structure: Zak is perfectly capable of running Nomad on his own (*someone tell him I do! Zak*). This means that straight away we are running at something less than fifty percent capacity utilisation on a normal day, and so we can gear up, in effect, when opportunities arise as they have recently. Capacity utilisation is also kept low by few investments, held for long periods. We have had the blessing of learning some big lessons early in life (there will be more). And we have worked out that, in any real sense, we do not know that much. In our opinion we have the right environment to think things through, think rationally, and come to meaningful long-term insights. Whether our insights are economic or not will be our fault, it will not be due to the environment in

which we work. Zak and I don't want to be busy; we want to be right.

Once it has been created, what is to be done with the slack? The best activities might be those that refresh the mind, broaden horizons and reinforce good habits, and it is in this spirit that I have become a governor of a failed school in south east London. What is interesting is not the reasons for the school's failure which seem common enough (unionised teachers employing 1970s teaching techniques, awful facilities and so on). What is interesting is the route out of the soup: incentives. Teachers who previously had no incentive compensation are being given bonuses for attendance (!) and improvements in class results. The children are being rewarded with house points for good work and behaviour, and deductions for poor work. But importantly, there are many more positive house points awarded than negative. This is a desire to be better system, not a punishment and condemnation system. There are other factors involved: new head teacher, new governors, school uniform, five-day teaching week (the previous failed school took Friday afternoons off – unbelievable!), but it is the incentives that reinforce the good behaviour. Other schools have undergone such a reformation with terrific results: for example at one south London school, which is run by the same team as my school, exam results for sixteen year olds have improved from a pass rate of 14% to over 90% in just over a decade. A good incentive scheme is so cheap compared to what is created.

### Incentives. Incentives. Incentives.

In business the question then arises: what do incentives encourage? From the perspective of investors in Nomad, the incentives are helpful if they raise the probability of a favourable destination for our investee firms. Let's take the incentives around high low retailing as compared to scale economics shared retailing. Under the first strategy operating costs are generally high as a result of operating inefficiencies, and prices are high to compensate. To attract customers some products are reduced in price on a temporary basis in the hope that whilst the customer is in the store, they may buy some non-discounted items too (some prices are therefore high and others low, hence the name). The incentives here are awful: customers are trained to buy on deal, be disloyal and shop around, and for the retailer the inefficiencies of pricing and repricing and the volatility of volumes are meaningful. The effect is that, after adjusting for one off reductions in price, sales are lower on a normalised basis than they would be otherwise, which in turn exacerbates operating cost inefficiencies. Yuck.

Scale economics shared operations are quite different. As the firm grows in size, scale savings are given back to the customer in the form of lower prices. The customer then reciprocates by purchasing more goods, which provides greater scale for the retailer who passes on the new savings as well. Yippee. This is why firms such as Costco enjoy sales per foot of retailing space four times greater than run-of-the-mill supermarkets. Scale economics shared incentivises customer reciprocation, and customer reciprocation is a super-factor in business performance.

Scale economics shared works across industries too with the effect that load factors at the low-price Malaysian airline, AirAsia, are superior to high-low flag carrying airlines. And it works online: Amazon have deployed it so well that Amazon's operating costs (per dollar of sales) plus its operating margin are less than some of its high street peers' costs (per dollar of sales). This offers the prospect that, in theory, Amazon's high street peers could price their products at net income breakeven and still not undercut Amazon's prices or profitability. For these high street competitors the game is over. They will leak revenues to more efficient rivals as customers respond to the incentive of consistently low prices and convenience. Over time

high street rivals, and less successful online rivals, will need to restructure, change their product, or go out of business. We estimate Amazon's immediate hinterland of high street rivals have combined revenues of US\$150bn in the US alone. If these firms go away over the next ten years, as Circuit City, Woolworths, Zavvi and others have recently, and Amazon picks up one dollar in ten of their sales, then this alone would be enough to quadruple Amazon's US revenues over the next decade.

Scale economics works well in bad economic times as well as good. On the busiest day in the run up to Christmas this year, order volumes at Amazon were 16% higher than the previous year and note this compares to industry-wide US retail sales which declined nearly ten percent in December, according to the commerce department! And at AirAsia revenues per seat per kilometer flown rose 33%, whilst costs per seat per kilometer flown excluding fuel declined 10% in the latest quarterly period. Our businesses are surging ahead, even if, in some cases, their share prices are half what they were twelve months ago. In the last few months Amazon has been priced in the market as if it would not grow in the future, despite some of the best growth prospects we can imagine. That is a very rare combination and, combined with other similarly cheap stocks in the partnership, was the basis for Nomad's reopening at the end of last year.

### Nomad Reopening

Whilst we had few redemptions as a result of the crisis, we also had few subscriptions. Indeed, if one ranked the subscribers by size, Zak and I were the second and third largest in October (!) and whilst it may have been a lot of money to us, it wasn't very much in the scheme of things! And still the opportunity set remains. The rational thing to do is to open Nomad whilst the price to value ratio remains very favourable and so, for the meantime, Nomad will remain open for subscriptions.

### A Word on Zimbabwe

Richard Zeckhauser, at his brilliant behavioural finance course at Harvard, asks attendees to answer various questions to which they are not likely to know the answer, for example, the surface area of Norway. The answer is to be expressed in five numbers: a median best guess, two numbers which represent the 25<sup>th</sup> and 75<sup>th</sup> percentile of what you think the answer may be, and two more representing the 99<sup>th</sup> and 1<sup>st</sup> percentile of what the number may be. The more confident one is of the answer the more bunched the figures would be. The less confident the wider the distribution. So, for the size of Norway a student's line of thinking may be as follows: I'm not sure how big Norway is but it looks kind of smallish (first mistake, our minds may picture a globe as if we were looking from above the equator, this has the effect of visually squashing the landmasses toward the poles. If we visualised the world as if we were hovering above the poles, on the other hand, we may form quite a different impression), so, I think Norway may be 250 miles long by 75 miles wide say, or 18,250 sq miles. I cannot be out by that much (oh yes you can) so I'll double and halve my best guess and that will be my range, so Norway is no bigger than say 40,000 miles and no smaller than 10,000 square miles, and I'll halve and double those answers for the 99<sup>th</sup> and 1<sup>st</sup> percentile. Turn to the end of this letter for the actual answer (but watch out, even the fact that I have led you through a worked example may affect your thinking!). It is a great test, and what it reveals is that, in aggregate, we tend to be far too confident that we know the answer to something that we don't.

If you had asked us for the range of possible outcomes to events in Zimbabwe, we would have given you a very wide distribution indeed, from immediate international rehabilitation to, well, continued looting, and I do not think our distribution would have been wide enough (Zak now tells me he forecast events exactly!) Most recently, the factor that effects Nomad is the suspension of trading on the Harare Stock Exchange. The market is not suspended as such, but as all the stockbrokers have failed to meet the minimum regulatory capital required by their licenses, this applies even to the international banks, the exchange might as well be suspended. The reason for the sudden impasse is that the settlement period for transactions in the banking system as a whole has been extended enormously as investigators, responding to the alleged presence of fraudulent cheques, have chosen to, perhaps personally we don't know, check the cheques in the banking system themselves. Nothing is settling or clearing in a hurry. As a concession to the stock exchange, the authorities have allowed the brokers to trade, but only if the Chairman of the custodian bank, in our case Barclays Plc., personally underwrites settlement in the event Nomad fails to deliver. Hmmm. We have not placed a call to Mr. Agius yet, or his CEO, John Varley, but we are not optimistic of a favourable response. As you may imagine, the financial system has stopped. And if there are no prices on the stock market, we cannot price our shares, nor price the unofficial exchange rate for the Zimbabwean dollar. We have no idea when trading will resume, it could be quite a long haul, and so the independent directors of Nomad's General Partner have taken the view that our Zimbabwean holdings should be valued at zero, as compared to 0.28% of Nomad at the end of November. Zak and I don't think our businesses are worth nought, indeed we know they are not but, then again, we cannot give you anything for your Zim shares either. So, for the meantime, zero it is.

### Happier Times

Let me finish with a story told by the radio presenter and car collector Chris Evans that has parallels to the stock market bargains of today and helps demonstrate the merits of doing some proprietary work, sniffing out a great investment, and holding forever. First a little background. In the late 1950s Ferrari motor cars successfully competed and won almost all the major GTO class races of the time, but by the early 1960s they had started to lose ground to new slippery shaped Aston Martins and the AC Cobra, amongst others. The solution was Ferrari's first wind tunnel designed car: the 250 GTO, which was launched in 1962. It was an instant success, and beautiful to boot. 250 GTO owner Paul Vesty recalls childhood memories of seeing five GTOs line up on the start of the Goodwood TT in Sussex, England "*immediately all the other cars looked ancient – instantly we all wanted one*". The car won almost everything going and became an immediate classic. It was also very rare: one hundred cars should have been built to qualify the vehicle for GT class racing but, in the end, only thirty-six were actually produced. The effect today is that fifty and sixty year olds, looking to buy their boyhood dream car, may have to pay world record prices, think U\$10 to U\$15m, the next time one sells at auction. After some successful seasons the GTO was replaced with faster models and during the mid 1960s Ferrari sold off its racing vehicles to enthusiasts. At about this time the third James Bond film, Goldfinger, was launched which featured the now iconic Aston Martin DB5. Back to Evan's story:

[In the mid 1960's] *"a very famous collector, who has one of the finest noses for sniffing out a deal, hears a whisper that the first James Bond Aston Martin DB5 may be for sale... The word is that for the right money, the original James Bond car can be bought directly from the movie studio. So he makes a few calls, he tracks down the production guy...*

*"It's gonna have to be 15 for the pair"*

*"You mean there are two?"*

*"Hey man this is show business, there is always two... at least"*

*"But 15 for the pair" says our man. "I wasn't counting on spending that much and I don't really want two – I just want one"*

*"When that is the deal. Take it or leave it."*

*... "Fifteen thousand pounds – a lot of money now, a load of money then. Our hero hesitates for a moment, but his nose knows better. It tells him to deal. He buys the car. The cash is to be paid on delivery of both vehicles. The day arrives, the trailer pulls up, the cars roll off. The invoice reads: FIFTEEN HUNDRED POUNDS. Yes, friends both original Bond cars for £1500, but it does not end there. Be prepared to run for the hills screaming. Our man then swaps one of the Bond cars for a GTO. That's a GTO for £750. That's the cheapest GTO ever and...he still has it today."*

Of such stuff are dreams made. Now, let me rephrase this story from the perspective of an equity investor. The collector thought outside the box, rolled up his sleeves, did some proprietary analytical work, and found a contrarian investment opportunity with great growth potential that few of his peers recognised at the time, lucked into a low price, owned it forever and, in the end, it did not matter what price he paid particularly, as the growth in underlying value made his purchase one of the best investments of all time. Zak and I aspire to such a road map.

### Thank You

To your eternal credit, Nomad's quirky approach to investing is respected by Nomad's partners. I do not think we have done our investors many favours as judged by Mr. Market's erratic marking of our investments last year and indeed our own avoidable mistakes such as those discussed in the last letter. Be that as it may, we have had no enquiries as to performance during a year in which Mr. Market and the media gave you lots of provocation. Net redemptions due to the crisis were less than two percent of the Partnership. Indeed, we received some lovely notes of support during the year, which are special to us, and mean more than funds under management any day. Thank you. Please do not underestimate the value of your considered patience and support to the Nomad ecosystem.

The commentary in the press is uniformly gloomy and this is serving to depress share prices. What we know is that prices are lower than a few years ago and corporate behaviour is improving. We mean no disrespect to those unfortunate enough to lose their jobs or caught up in other people's too-busy-to-think mistakes and scandals, but from the perspective of an investor there is less to worry about today than there was a few years ago. Indeed, I doubt that worrying is the solution to anything particularly: far better planning. We are reminded of Winston Churchill's story of a man on his deathbed: *I have had a lot of trouble in my life, says the dying man, most of which never happened.* It may not feel like it but for a long-term

investor this is the best of times not the worst. It is in this environment that people sell their GTOs for £750. Take heart and look to the horizon.

Yours sincerely

Nicholas Sleep

The surface area of Norway is 148,746 square miles, according to Wikipedia.

\* Sleep, Zakaria and Company, Ltd., was appointed as investment advisor to the Nomad Investment Partnership with effect from September 12<sup>th</sup> 2006, replacing Marathon Asset Management who had been investment advisor to the Partnership since inception. Prior to 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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