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## Nomad Investment Partnership

### Annual Letter

#### Cumulative returns for the period ended December 31<sup>st</sup>, 2012

To December 31 <sup>st</sup> , 2012:	<u>Nomad Investment</u> <u>Partnership</u>	<u>MSCI World</u> <u>Index (net) US\$</u>
Trailing:	%	%
One year	39.8	15.8
Two years	25.9	9.4
Three years	81.2	22.3
Four years	210.7	59.0
Five years	70.5	-5.7
Six years	106.7	2.8
Seven years	134.8	23.5
Eight years	156.7	35.2
Nine years	214.2	55.1
Ten years	464.3	106.4
Eleven years	471.6	63.3
Since inception (September 10 <sup>th</sup> , 2001)	529.4	71.3
Annualized since inception:	%	%
Before performance fees	17.7	4.9
After performance fees	15.1	
Value of a dollar invested at inception (pre-fees)	\$6.29	\$1.71

The figures above are unaudited, presented on a cumulative, percentage gain basis and, as ever, are before fees. We present results in this way as Nomad's refundable performance fee and time dependent performance fee hurdle mean that the net-of-all- fees results will vary with subscription date, and from investor to investor. Partners will, therefore, each have their own, unique, net-of-all fees experience of investing in Nomad. As a guide, we have also detailed the net-of-all-fees results from one point in time, in this case since inception. An index is used in the table to crudely place our results in context with a broad swathe of share prices from around the world. One of the reasons that Nomad is Nomad is that Zak and I spend almost no time thinking about stock market indices. We do not feel strongly about the merits, or otherwise, of this particular index, indeed its continued inclusion here has more to do with consistency than accuracy, and we would encourage partners to employ another benchmark if they feel it is more helpful to them. Whatever the yardstick, we ask only that Nomad be compared over the very long-term. Below, the same pre-fee results are presented in discrete annual increments. In our opinion, it is probably the upper table that is most useful in assessing long-term investment performance.

To December 31 <sup>st</sup> :	<u>Nomad Investment Partnership</u>	<u>MSCI World Index (net) US\$</u>
Calendar Year Results:	%	%
2012	39.8	15.8
2011	-9.9	-5.5
2010	43.9	11.8
2009	71.5	30.0
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 September 10 <sup>th</sup> )	10.1	3.6

A US dollar invested in Nomad at inception has grown to be worth \$4.93, after fees, as of January 1<sup>st</sup>, 2013, whilst a dollar invested over the same period in the average share, as reflected in the index above, would be worth around \$1.71. Put another way, net asset value (i.e. after fees) has compounded at 15.1% per annum, whilst the index has managed 4.9%.

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*“Don’t just do something, stand there!”*

The White Rabbit, Alice in Wonderland.

All is quiet at Galactic HQ.

Each day Zak and I shuffle in, swop trainers for slippers, pull up a pile of annual reports and set about analysing and re-analysing our investments. Routinely we try to kill our companies (they can be killed!), and we sift prospective investments. This week: a Glaswegian office property (in administration) – running yield 22%, we kid you not; a Thai big box retailer – scaling laws work in Thailand just as they do in Seattle; and a large pharmaceutical business (whose Chief Executive does not think it worth mentioning a multi-billion dollar acquisition a year after it was made!). The research continues but, as far as purchase or sale transactions in Nomad are concerned, we are inactive. Inactive except, perhaps, for the observation, seldom made, that the decision not to do something is still an active decision; it is just that the accountants don’t capture it. We have, broadly, the businesses we want in Nomad and see little advantage to fiddling.

And so it should be. If you did not buy the companies you always wished you had owned when they were on fire sale over the last few years then, when exactly are you going to buy them?

Nomad’s businesses, to generalise, are run by their founders and the businesses are blessed with cultures that see part of their identity in low operating costs: Costco Wholesale measures costs in basis points and at Amazon.com they take the light bulbs out of the vending machines

to save money. In another sphere, the Olympic Team GB Cycling coach and Sky Tour de France Chief (now Sir) Dave Brailsford might refer to this type of behaviour as seeking “*the aggregation of marginal gains*”. Just as it leads to gold medals and yellow jerseys, its effect is that AirAsia, for example, is the lowest cost airline in the world. Good things follow when you care about the pennies.

Zak and I have come to appreciate the value in retreating a little from endless stock analysis. From time to time we swap slippers for brogues and head out into the world with the expectation that what we learn through investing helps us in other activities outside the office, and what we learn doing other activities helps us as investors. I have my school turnaround project, Zak has various charity projects and, together with members of his family, has set up a children’s activity center. In this letter I thought I might describe some of these activities.

When we visited Carpetright, a UK carpet retailer, a few years ago we spent the morning with its founder, Lord Harris, discussing his firm and the industry. Lord Harris is a great advocate of watching the pennies. One of his store managers told us that his boss had balked at the cost of new price tags whenever the shops had a sale. To begin with he made the store managers use both sides of the old price tags, at least this would halve the tag budget, but the real saving came from using the same card with replaceable, reusable numbers. It may seem trivial, but the saving has been in the tens of thousands of pounds. Lord Harris is a wealthy, successful man who does not need to work and so, over lunch, we asked him what still gets him motivated, at the age of 66, “*Oh*”, he said “*you should see the academies*”.

When schools fail in the UK, and the definition of failure is appallingly low exam results sustained through three annual warnings, oversight of the school is taken away from the local education authority and given to an independent body, in this case Lord Harris’ Federation of Academies. Once inside the Federation the school (now called an academy) is free to hire a new head, new governors and set its own employment contracts. In the case of the school I became involved with, all three were necessary, the result being an almost complete turnover in staff and governors. It is brutal, but necessary, in order to change the culture. Gone are protected, high salaried employment, a clock watching mentality, and indifference to the pupils’ education, and instead teachers are provided with bonuses for attendance and improved exam results.

Not that there is a lot of money to go around. The school does not receive the additional funding that may come with a location in inner London (the school is just over the border and classified, unlike some other local schools, as outer London), and the catchment area is not sufficiently poor to warrant aid, but then it is not wealthy either. The effect is that funding per pupil is one of the lowest in South London and, to put the figure in perspective, funding per child is around one third of the school fees paid for private education at nearby London day schools. The comparison is not quite apples to apples as private schools have to fund their property, but quite how the school runs inside its budget is extraordinary. Every penny is watched, and resources are spent on the right things such as rewarding good practice in teachers and funding extra-curricular activities. It is amazing to see the result: after five years - and with no more funding than the predecessor school - an exam failure rate of around 85% will in the near future, become an 85% pass rate (fingers crossed!). It is quite something to witness.

Zak’s family’s activity centre is an interesting tale. The centre is located in a light industrial building and consists of climbing structures and slides set in a three story netted frame, a

restaurant for the parents and separate entertainment rooms for birthday parties. There is little endemically proprietary about the business, real estate is relatively cheap, the climbing frames are easily purchased and catering is catering. The operation has relatively high fixed costs, which means that incremental revenues appear disproportionately valuable and so centres usually compete on price in the hope of attracting customers. The problem is the supply-side, which periodically gets out of control, as a hopeful newcomer sets up another operation in the same catchment area.

It is tempting in managing such an operation to pay the minimum wage. However, after a short while the family found that the quality of staff improved noticeably if, Costco-like, they paid a bit more. Instead of employing relatively young, unskilled (shop) assistants, the centre began attracting people with experience of working with young children, such as nursery school assistants, who cared about the children. The centre polled customers to find out who had made the decision to visit. Contrary to expectations it wasn't child nagging that forced a decision, but parents wanting something to do with (out!) the kids. What parents care about is cleanliness, new fittings and a decent cup of coffee, so money was spent on these items, not on wowing the children with the newest slide. The activities were keenly priced but the centre found that customers responded more to relative prices and so rates were kept just under those of the competition, rather than ruinously low.

At the end of the first year the centre was running at a loss, but one of the competing centres had closed down. Last year the business was breakeven and, just recently, after the demise of a second competitor (with sizeable debts and which had, interestingly, been run by hired hands and not the proprietor) revenues have jumped by a quarter and the activity centre is now earning proper profits.

It is tempting for Zak's relatives to think the battle has been won and, in line with many a business school case study, now gently raise prices to earn a monopolist's rent. However, Zak's advice to his relatives is counter-intuitive: take prices down (he is a hard man to have on your board). The risk with super-normal profitability is that the profits are an incentive for a new competitor: far better, Zak argues, to earn less, but for a much longer time. This is tough advice for the family members who have been cleaning loos and Hoovering floors at eight o'clock at night, but the long-term logic is undeniable. To their very great credit the family are once again lowering prices just a little.

Zak's family's activity centre beat the competition because they understood the difference between good costs (nice staff, clean loos, good coffee) and bad costs (a whizzo new slide) and invested appropriately. They were smart enough to poll customers and observe the influence of pricing (there was no need to over-discount). The operation was equity funded and did not include a third party in the capital structure (bank debt). But most of all it was founder managed and they cared. Watching the pennies and investing carefully has led to the "aggregation of marginal gains" and financial success, and as such it has much in common with the investments that populate Nomad. It has been fun for Zak and me to practice in the real world, what we preach in investing.

Not that we get it right all the time. The agent behind the high yielding Glaswegian office property told us that he had just re-let his first building, twenty-five years later.

*"The rent then was £4.26 per foot; it was never going to sell for a round number because both parties cared about the pennies. I have just re-let it for £42 per foot, a round number.*

*You only ever deal in round numbers these days. People don't care about the pennies anymore, that's why no one has got any money,"* he told us.

Zak and I spend all our time thinking about good business practices and we greatly admire firms that watch the pennies but we looked at our shoes as we were told this story - the rent at Galactic HQ is...ahem...I will whisper this...a round number.

We still have much to learn.

### Housekeeping.

Earlier this month Phoenix Financial Services in Dublin, Nomad's administrator, announced that they have agreed to a management buy-out from the Phoenix Group. Phoenix Dublin's CEO, Gavin Gray, and his team have done a first rate job for Nomad's partners over the years. Zak and I, and Nomad's independent directors wish, indeed, Gavin and his team deserve, every success in the future. The transaction, which is subject to regulatory approval, will result in Nomad rising from approximately one-quarter of group revenues, to around three-quarters of the new (MBO) firm's revenues. Gavin does not want it to stay that way and will look to grow his new firm free from the demands of a parent company (sound familiar?). Zak and I, and Nomad's independent directors, support the idea of Nomad's administrator being owner managed (normally terrific for service quality) and hope that Nomad's future good performance will stop our proportionate share of Gavin's business from falling too fast! I don't think it is a fair race, Gavin is far too good an administrator to remain small for long. We wish them all the best.

As always, thank you for your quiet, gentle hand on the tiller. It is important to Zak and me to be in an ecosystem that gives us the mental freedom to think rationally and avoid the psychological pitfalls that pepper the industry. Do not underestimate the important role you play in maintaining a healthy ecosystem.

We wish you a very Happy New Year,

Nicholas Sleep

### Our footnotes

There is, we are told, a ticket kiosk at a railway station somewhere in India with a sign above the window that reads, "*No Bamboozlement Here*". It is in the same spirit that we attempt these cautionary words. Disclaimers boil down to the following statement – if you choose to believe any of this, then you are on your own. Yikes! It will be hard for us to escape this conclusion too, and it makes little sense for us to do anything but disclaim liability for errors, omissions and offer no warranties – please, check everything we say, let us know when we are wrong and forgive our errors. We do promise you this: we are human, we make mistakes, but our mistakes are honest ones. Although we do not intend to mislead, we also cannot guarantee the information in these letters, or that some of our ideas may be interpreted in ways we do not intend. As investors we are trying to do as good a job as we can and we write these letters in good faith to inform and educate partners on our actions and thinking in the context of the Partnership. We hope that they will be read in the same spirit in which they are written.

Common sense tells you that the price and value of shares can vary greatly, and whilst we do not aim for this, we also recognize that permanent impairment of capital is possible. Our Partnership is concentrated in relatively few investments, perhaps more concentrated than many others, and as such our results will be more volatile than

many of our peers. Nomad is also a very long-term Partnership. We do not think it is suitable for investors with time frames less than five years. We also do not think Nomad is suitable for investors overly conflicted with principal-agent issues. If you are at all uncomfortable then, we suspect, Nomad is not for you.

The Nomad Investment Partnership has had two General Partners: Marathon Asset Management for the period from inception in 2001 to September 2006, and Sleep, Zakaria and Company from September 2006 until the present day. Zak and I have been responsible for the investment decisions of the Partnership since inception, formerly as employees of Marathon and then at our own firm, which was set up for the purpose of managing Nomad. The adventure continues...

#### Some notes on housekeeping (stay awake at the back!)

This is the annual letter and, combined with the interim letter sent to investors in July, is the main format we use to communicate to our partners. In these letters we have tried to honestly and thoroughly provide all the information we would seek if the tables were turned and we were investors in someone else's fund. We own shares for very long periods and we are conscious that more frequent or detailed reporting may be unnecessary and even counterproductive. A copy of our magnum opus, the full Collection of Letters, is available upon request from Amanda at Galactic HQ (amanda@sleepzakaria.co.uk). Lots of coffee required. Partners in Nomad will also receive a full copy of our Schedule of Investments by separate post, every six months, which lists all of our investments in detail. In addition, in the spring you will receive Nomad's annual accounts, audited by Grant Thornton. Each month statements of account are sent to you by Nomad's administrator (not us!), Phoenix Financial Services in Dublin, Eire. Please call Gavin Gray and his team (+353 18 450 8161) with your statement queries. As should taxable US investors as Gavin and his team prepare their tax certificates (1099s) as well.

Clients should always consider Zak and me to be available at the end of the phone, and our (somewhat shabby) front door open to visitors. And whilst we welcome your company, please don't be too disappointed if we don't have much that is new to say: we hope it is in these letters already.

#### Legal footnotes

Performance numbers are produced by Phoenix Fund Services, Nomad's administrator, and have been audited by Ernst and Young to 2011, and from then on by Grant Thornton, in their annual audits that follow publication of our letters.

In our letters we refer to both limited partners in the Partnership, and common shareholders in the Nomad Investment Company (feeder fund) as "partners". We do this to convey a relationship we seek in which our investors are partners in a shared experience and destiny, in which they too have something to contribute. We do not mean to suggest that there is a partnership, in the strict legal sense of the word, between the shareholders in the feeder fund and Nomad, or Sleep, Zakaria and Company, Ltd.

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The Nomad Investment Partnership is not a recognized scheme under the Financial Services and Markets Act 2000 ("FSMA"). Given the nature of Nomad's investor base, recourse to the FSA and the Financial Services Compensation Scheme may be limited