

Sleep, Zakaria and Company, Ltd.

1a, Burnsall Street
London
England
SW3 3SR

T: +44 (0) 20 7101 1960

F: +44 (0) 20 7101 1965

Nomad Investment Partnership

Interim Letter

For the period ended June 30th, 2010.

Cumulative results to June 30 th , 2010.	<u>Nomad Investment Partnership</u>	<u>MSCI World Index (net) US\$</u>
Trailing:		
One year	+38.1%	+10.2%
Two years	+15.4	-22.3
Three years	-5.6	-30.6
Four years	+22.3	-13.9
Five years	+34.7	+0.3
Six years	+70.0	+10.4
Seven years	+139.8	+36.9
Eight years	+195.0	+33.6
Since inception (Sept 10 th 2001)	+238.2	+26.2
Annualized since inception		
Before performance fees	+14.8%	
After performance fees	+12.5	+2.7%

The figures above are unaudited, presented on a cumulative basis and, as ever, are before fees. 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. Investors will, therefore, have their own unique net-of-all fees experience of investing in Nomad. As a guide we have also detailed overleaf the net-of-all-fees result from one point in time, in this case since inception. An index is used in the table to place our results in context with a broad swathe of share prices from around the world. We do not feel strongly about the merits of the index we have chosen, and Partners may wish to use another. 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 the upper table that is most useful in assessing long-term investment performance.

Calendar Year Results to June 30th:	<u>Nomad Investment Partnership</u>	<u>MSCI World Index (net) US\$</u>
2010 year to date	-2.7%	-9.8%
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 Sept 10 th 2001)	+10.1	+3.6

The New Year brought Nomad's tenth calendar year of operations. Since we began, a dollar invested in Nomad at inception has grown to be worth \$2.82 net-of-all-fees, as of June 30th, whilst a dollar invested over the same period in the average share, as reflected in the index above, would be worth around \$1.26. Put another way, net asset value has compounded at 12.5% per annum, whilst the index has managed 2.7%.

Some Observations on the Nature of Comparative Advantages

There are, perhaps, few things finer than the pleasure of finding out something new. Discovery is one of the joys of life and, in our opinion, is one of the real thrills of the investment process. The cumulative learning that results leads to what Berkshire Hathaway Vice-Chairman Charlie Munger calls "*worldly wisdom*". Worldly wisdom is a good phrase for the intellectual capital with which investment decisions are made and, at the end of the day, it is the source of any superior investment results we may enjoy. So, when analysing a firm, one just knows one is on to a good thing when one learns something new and the penny finally drops. And many times more fortunate if that insight can be applied more generally across businesses.

Take, for example, a recent research trip to a Welsh insurance company. The firm's products are nothing special, primary auto insurance sold to customers who buy mainly due to the legal requirement to be insured on the public roads. There is little product differentiation across the industry and the customer purchase decision is usually driven by price. This is a soul-less relationship: it is near on impossible to get customers to love their insurance companies and, for their part, insurance companies don't give the impression they love their customers much either. Be that as it may, the firm we visited has a wonderful track record of financial results going back decades. Not just good by insurance industry standards (a low hurdle to jump if ever there was one), but good by any standards. So, what is going on?

It is tempting when analysing such situations to look for the big thing the firm does right. In effect, one is looking for the smoking gun that explains the firm's success. A smoking gun may be a vivid image, but the world does not always work like that. I should have known better when I asked what big idea had led to the firm's success: "*No, no, Nick, there is no secret sauce here*", one senior executive explained, "*we don't do one thing brilliantly, we do many, many things slightly better than others*". I have heard this line frequently over the last

twenty or so years, and I have always dismissed it as a fig leaf covering the lack of any real corporate advantage. And I think that all this time I may have been wrong.

Take Costco Wholesale: Costco's advantage is its very low-cost base, but where does that come from? Not from low-cost land, or cheap wages or any one big thing but from a thousand daily decisions to save money where it need not be spent. This saving is then returned to customers in the form of lower prices, the customer reciprocates and purchases more goods and so begins a virtuous feedback loop. The firm's advantage starts with 147,000 employees at 566 warehouses making multiple daily decisions regarding U\$68bn worth of annual costs. It's thousands of people caring about thousands of things a little more, perhaps, than may occur at other retailers. No fig leaf here. When Zak and I met Jim Sinegal, Costco's CEO, Jim suddenly stopped in mid-sentence, his face lit up, "*I must show you this*" he said and disappeared into a filing cabinet. He emerged with a memo from 1967 written by Sol Price, Fed-Mart's founder (the predecessor firm to Costco), "*here you can have a copy of this*" he said, and that copy is framed on our office wall. The memo says this,

"Although we are all interested in margin, it must never be done at the expense of our philosophy. Margin must be obtained by better buying, emphasis on selling the kind of goods we want to sell, operating efficiencies, lower markdowns, greater turnover, etc. Increasing the retail prices and justifying it on the basis that we are still "competitive" could lead to a rude awakening as it has with so many. Let us concentrate on how cheap we can bring things to the people, rather than how much the traffic will bear, and when the race is over Fed-Mart will be there". [The best summary of the business case for scale economics shared we have come across].

Forty-three years later, almost to the day, and Costco is the most valuable retailer of its type in the world. Cultures that care about the little things all the time are very hard to create and, in the opinion of Amazon.com founder Jeff Bezos, almost impossible to create if not put in place at the firm's genesis. (It may be worth noting that, in contrast, most businesses cut costs sporadically, often-in response to a crisis, as part of plan B as it were. With their backs to the wall, good costs (investment spending) may be cut as well as bad costs (bloat), with the result that the savings prove counter-productive in the long run). The Welsh insurance company was founded by a man who cared passionately about the little savings, and he institutionalised this orientation into the culture of the firm from the beginning. It was the way they lived; it was part of their *raison d'être*: it was plan A. And they shared that saving with their customers. Although I was slow to grasp the point, the insurance firm's advantage was very similar to that which had built Costco and builds Amazon today.

My mistake in not recognising that these businesses share similar roots ("*D'oh!*" as Homer Simpson might say) might be termed by psychologists as a "*framing*" error. When looking for an explanation to a situation the brain tends to latch on to what can be easily found to "frame" the situation, and if what is easily found is also vivid, then the brain stops looking for another explanation. I had gone looking for what I thought ought to be there, a vivid smoking gun such as a brand name, a location, a clever re-insurance contract, or a patent. However, there is no a priori reason why a comparative advantage should be one big thing, any more than many smaller things. Indeed, an interlocking, self-reinforcing network of small actions may be more successful than one big thing. Let me explain.

Take a one-big-thing-firm, such as a drug company, for example. A successful drug firm does

not need to be particularly good at marketing, manufacturing, or research and development for that matter if, through a patent, it has a legal monopoly on a drug. But just look, if you will, at how fragile the drug company ecosystem is. A rival could displace it at any time with a better chemical and the firm would be left with little to fall back on, certainly not marketing, R&D, and manufacturing. Its period of exceptional profitability may therefore be quite finite and the big drug firms wrestle with this issue today.

Contrast this with a scale economics business: To better an incumbent's cost base a rival would have to be superior at, not one thing, but a million little actions – a far harder task. Amazon's letter to shareholders this year contains the following section:

“...We believe that focusing our energy on the controllable inputs to our business is the most effective way to maximise our financial outputs over time...we've been using this same annual [goal setting] process for many years. For 2010, we have 452 detailed goals, with owners, deliverables and targeted completion dates”.

At Amazon one employee initiative to remove the light bulbs from the vending machines (really!) saves the firm U\$20,000 per annum! At the Welsh insurance company the penny dropped: firms that have a process to do many things a little better than their rivals may be less risky than firms that do one thing right because their future success is more predictable. They are simply harder to beat. And if they are harder to beat then they may be very valuable businesses indeed.

The Subtle Implication for Long-Term Investors

The opportunity for Nomad's investors comes from realising to whom these firms are more valuable. Certainly not the short-term investor, who will be indifferent as to whether Amazon, Asos or Air Asia will be the most valuable retailer/fashion e-tailer/airline in the world in ten years' time. The institutional fund manager may be similarly indifferent. This collective professional myopia presents the true long-term investor with the spoils, but the mechanism for this wealth transfer from short-term holder to long-term investor is subtle.

When investors value a business they have in their minds, consciously or not, a decision tree with the various branches leading to all possible futures and probabilities attached to those branches. The share price can be thought of as an aggregate of the probability weighted value of these branches. The problem, as Santa-Fe Institute scientist Ole Peters most recently pointed out (SFI Bulletin 2009, volume 24), is that this is not an accurate representation of what the future will be! The next step for the company will not be to visit all of those branches simultaneously. In reality the firm in question will only visit one of those branches before proceeding to the next and so on. Short-term investors spend their time trying to handicap the odds of each branch.

Guessing which-branch-next can be a crowded trade, but it's fine, as far as it goes. However, it rather misses the big picture, in our opinion. We would propose that some businesses, once they have progressed down the first favourable branch, stand a much greater chance of progressing down the second favourable branch, and then the third, as a virtuous feedback loop builds. The process takes time, but a favourable result at any one stage increases the chances of success further down the line, as it were. Think of it as a business' culture.

Take Air Asia: The firm was born with a no frills, cost culture with the result that, we estimate, it is the lowest cost airline in the world: this is favourable branch one. Favourable branch two: the employees take pride in the firm, suggest their own savings and the savings are implemented. Branch three: the savings exceed the peer group and are given back to customers in the form of lower prices. Branch four: the customer reciprocates and revenues rise. Branch five: further scale advantages lead to more savings per seat flown. Branch six: further customer reciprocation. Branch seven: the network builds and crowds out other, less efficient airlines. Branch eight: competitors go out of business?

The point is that the odds associated with any of these branches are not static but, in a hugely important way, they improve as one travels from branch to branch. Imagine the payoff in a game with these attributes? If investors recognise the inevitability of these improving odds they are also usually indifferent to them, perhaps viewing the eventual greatness of a business as simply outside their time horizon. Nevertheless, the effect of this indifference on share prices is to leave long-term success undiscounted (note, share prices are an aggregate of all possible future worlds, not the actual future) and the rewards from that observation may be enormous for the patient few. We certainly expect so.

The Following Paragraph is Important

The thoughtful, easy patience of our clients therefore has an important part to play in the process. It is the rational way to respond to our investment in firms that are playing a long game, as it completes the favourable ecosystem. Please do not underestimate the importance of your role in the process. You do us a great honour by being a calm hand on the tiller. Thank you.

Readers that make it to the end of our letters (we may be flattering ourselves), including the footnotes (we may be deluding ourselves!), may recall the story we retold of the Ferrari 250 GTO bought by a collector in the 1960s for the effective price of £750. The beauty of the story is that although the car is one of the most valuable in the world, the collector still has his car today. A different 250 GTO has recently changed hands, and the price...US\$20m! It makes Nomad's tripling look rather pedestrian. Better get back to those annual reports.

As always, *"take heart and look to the horizon..."*. Enjoy the summer.

Yours sincerely

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 investors 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, Ltd. 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 interim letter and, combined with the annual letter sent to investors in January, is the main format we use to communicate to our investors. 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. Investors 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 Ernst and Young, which was produced in record time this year and sent to investors in early March. Each month statements of account are sent to you by Nomad's administrator (not us!), Phoenix Financial Services in Dublin, Ireland. 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 the letters already.

Legal Footnotes

Performance numbers are produced by Phoenix Fund Services, Nomad's administrator, and are audited by Ernst and Young in their annual audit, which follows 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.

This document is issued by Sleep, Zakaria and Company, Ltd., which is authorized and regulated by the Financial Services Authority (FSA) (No. 451772). This document is only sent to people who have an interest in receiving it and is not for onward distribution. This communication is being made only to and is directed only at: (a) persons outside the United Kingdom; (b) investment professionals, as defined in Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the "Order"); or (c) high net worth companies, unincorporated associations and partnerships and trustees of high value trusts as described in Article 49(2) (a) and (d) of the Order, and other persons to whom it may otherwise lawfully be communicated, falling within Article 49(1) of the Order. 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. Registered office: 1a, Burnsall Street, London, SW3 3SR, England. © Sleep, Zakaria and Company, Ltd