

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, 2008

To June 30 th , 2008	<u>Nomad Investment Partnership</u> *	<u>MSCI World Index (net) US\$</u>
Trailing:		
One year	-18.2%	-10.7%
Two years	5.9	10.4
Three years	16.7	29.1
Four years	47.3	42.1
Five years	107.8	76.1
Six years	155.6	71.9
Since inception (Sept 10 th 2001)	193.0	62.5
Annualized since inception		
Before performance fees	+17.1%	
After performance fees	+14.1	+7.4%

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 , 2008:	<u>Nomad Investment Partnership</u>	<u>MSCI World Index (net) US\$</u>
Calendar Year Results:		
2008 (year to date)	-20.8%	-10.6%
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

Since the beginning of the year limited partnership interests in the Nomad Investment Partnership and shareholder interests in the Nomad Investment Company have declined around twenty percent in price and means that a dollar invested in the Partnership at inception would now be valued at around two dollars and ninety-three cents. As usual we quote performance before performance fee payments, as Nomad's time dependent hurdle means that investors with different purchase dates will also have different net-of-all fees experiences. The subtraction of performance fees from the figures above means that, whatever the experience, it will be less favourable than those presented. The sole exception being the first six months of this year, when the refundable performance fee reserve was, indeed, refunded to the credit of limited partners and shareholders. In effect, investors as of January 1st got something back, and that something was a gain of around two and a half percent of net asset value (NAV). At the end of 2007, that same two and a half percent of NAV looked like performance fees in waiting to be paid to Zak and me over time. Today, if you were with us on January 1st, it sits in your account. This equitable system might be good for the soul, but it is not great for cocktail party bragging rights – Zak and I look at our shoes as we are asked *“let me get this straight: you paid money back to your clients?”* Whilst we don't care particularly for our peers' approval, we are working hard to at least be able to look them in the eye. And there is only one-way to do that: better performance over time.

All this compares with an index return of around minus eleven percent and means that a dollar invested in the markets at Nomad's inception is worth around one dollar and sixty-two cents today. We were a little surprised to discover the index had done so well when some of the country indices are down between thirteen percent (for the S&P500) and twenty-four percent (for the DJ Euro Stoxx 50, in local currency terms, source, Bloomberg), although the weakness of the dollar means that returns to a US investor from assets held abroad will be somewhat better. Our curiosity for decomposing index returns, fleeting at the best of times, was tempered by Morgan Stanley's request for a subscription fee to unlock their index composition methodology. Too expensive at any price was our conclusion; it makes little difference to us what the indices are doing, and we decided to save the money and keep expenses down. Index envy is not a route to outsized returns and at the end of the day it is blindingly obvious that our relative returns are what they are because we don't own what everyone else is chasing, but more on that later in this letter.

Not since the Asian crisis do I think that Zak and I have been so “wrong” as measured by subsequent declines in share prices, so quickly after purchase as we have been in the last twelve months. We consider ourselves contrarian, value-based investors. Ordinarily what we are buying is hated and reasonable value. When investments go from hated and reasonable to despised and cheap something is normally up in the markets. And what is up will be the subject of this letter.

In our experience investment managers tend to discuss individual stocks as a marketing tool. People like stock names. Others do not discuss stocks at all, either they understand the powerful psychological reasons for not doing so, or perhaps own shares for such short periods that there is little to be imparted. We would like to aim for a third route. I came across this Chinese proverb in a cookbook, of all places, but it sums up our approach to imparting information: *“Tell me and I'll forget, show me and I may remember, involve me and I'll understand”*. It is in this spirit that we will discuss three recent “wrong” purchases, of firms in three different industries on three different continents. (It seems our debt, kiss-of-death-purchasing-skills know no industrial or geographical bounds. A note to company management: if you receive a call from us asking for an exploratory meeting with a view to

Nomad making an investment and you care about your stock's short-term performance – don't take our call!) In this letter we will describe the greatest source of risk (as we define risk: the permanent loss of value per share) in the portfolio today. Finally, we will discuss perhaps the most important issue for all investors: duration – or, to put it another way, knowing who you are. First of all, let's illustrate the state of the portfolio with three stock examples. Nomad is the largest foreign shareholder in the first; the largest overall shareholder in the second, and Nomad is no longer a shareholder in the final company, although it was during the last six months.

Air Asia, Games Workshop and MBIA

*"There must be some way out of here, said the joker to the thief,
There's too much confusion, I can't get no relief.
Businessmen, they drink my wine, plowmen dig my earth, None of
them along the line know what any of it is worth."*

Source: "All Along the Watchtower" from the album "John Wesley Harding"
by Bob Dylan, 1967

Air Asia is Asia's largest low-cost airline and is probably the lowest cost airline in the world. The firm has borrowed heavily from Southwest Airline's model of operations (a point-to-point network configuration, on-line ticket sales, no reserved seating, one plane type). The effect is that costs including fuel are around 3c (US) per seat per kilometer (as of December 2007). Costs are very important when the product is, more or less, an undifferentiated commodity, and 3c compares with around 4.5c at Ryanair, 5.5c at Southwest or more importantly 4.5c at rival Malaysian Airlines. This cost advantage is shared with the customers in the form of low fares, although the firm has borrowed from Ryanair as well who extended the Southwest model to include revenue enhancements such as sales incentives for cabin staff, ancillary products and charging for complexity such as multiple bags. Even after allowing for these add-ons average revenue per seat kilometer at Air Asia is less than costs per seat kilometer at Malaysian Airlines! For example, our first enquiry on-line revealed that a flight between Kuala Lumpur and Bangkok, a distance of 730 miles (roughly the same as New York to Chicago), one way, booked a few months in advance can be had for M\$75, or U\$22. That's U\$8 per ticket cheaper than Malaysian Airline's super discounted fare, or U\$120 cheaper than the normal Malaysian fare. The product is relaxed and cheerful and the image is not unlike the early days of Southwest Airlines when "*Southwest's low fares and service were as outrageous as its uniforms*", (source: "Nuts! Southwest Airline's Crazy Recipe for Business and Personal success" by Freiberg and Freiberg), although Zak tells me the knee-length, high-heeled boots worn by 1970s Southwest cabin staff were not evident when we visited Air Asia (and boy, did he look!). The customer, unsurprisingly, reciprocates, and the planes run (in airline terms) full.

Air Asia is an example of scale-economics shared, which like Amazon, Costco, Carpetright and elements of other businesses in the portfolio (Geico, Nebraska Furniture Mart) have come to dominate Nomad (around 45% of the portfolio). Air Asia is the first sizeable, professional, entrepreneur owned and run low-cost airline to operate in Asia and as the firm began operations in 2002 these are pioneering days. For example, we do not know how big the market for low-cost travel is in Asia, although U\$22 to Bangkok strikes us as market stimulating. Joint venture operations in Thailand and Indonesia offer a population base seven times the domestic Malaysian market and it is for this reason that the firm has 175 A320

aircraft on order. The negotiated price of the A320s is, as far as we can tell, the lowest price paid by anybody for A320s and the firm has secured a guaranteed lowest price for an Asian carrier from Airbus for its planes. On paper then, Air Asia could be the most fantastic business.

But there are wrinkles: funding for the new planes is not entirely secured, and lenders are twitchy. 175 aircraft is a huge amount of capacity (one third the size of Southwest which has been in operation for 40 years). Asian nations all feel they must have a flag, a song, a national car and a flag carrier. Malaysian Airline Systems, long the government supported inefficient flag carrier is resurgent and is leading a price war. Oil is U\$140 a barrel.

Even so, the firm earns a reasonable spread over the cost of capital on its aircraft, whilst forcing pricing on other airlines which leaves them operating at sub economic returns. This is a powerful combination and implies that the business will win in the marketplace in the end. We have no ego invested our analysis (at least, I don't think we do: if you want to make rational decisions leave your ego behind), outcomes are leveraged and perfectly reasonable people could come to different conclusions as to the firm's investment merits. However, we do struggle with the price of the shares in the stock market today, which appears to value the firm at a meaningful discount to the value of the company owned fleet of planes. In short, the market has concluded that Air Asia, despite the potential outlined above, should not exist. This is nonsense; as such a valuation would imply that Southeast Asians, who are some of the most price conscious people on the planet, don't want cheap airfares!

Games Workshop

Games Workshop makes, distributes, retails and fosters the Warhammer family of tabletop games, think: modern equivalent of tin military soldiers. It is the largest firm of its kind in the world, although this is a small, but growing market. The customers are mainly boys between the age of 11 and 14 (no longer children, but before an interest in girls takes over!) and growth comes, in part, from word of mouth. Hobbyists must have the same soldiers as each other to comply with the stories that surround the battle scenes (otherwise, why are these sides fighting?) and so Warhammer is a standard and, if you want to play with your friends, you have to come to our shops. The firm grew steadily and profitably, if unspectacularly for many years until, that is, the Lord of the Rings line of models. These were very successful from the perspective of revenues and cash flow. However, windfall Lord of the Rings profits were invested in huge manufacturing facilities (that now run at 30% utilisation), funded new shops in marginal geographies, and a general complacency with the business set in, as the following excerpt from the Chairman's preamble to the 2007 accounts makes clear:

“So who was the enemy?”

“Is the world turning in such a way that mankind no longer wants or needs hobbies? No. All the evidence I see, with growing prosperity and increasing leisure time, is an increase in hobbies. Perhaps it is just collecting, painting and wargaming with miniatures that is passé? The evidence again says no. Too many of our stores around the world and their neighbouring independent accounts are in good healthy growth for that to be true. Have computer games, and especially these new online role- playing games, finally bitten Games Workshop? We have lived in happy harmony with computer games for our entire business life, our customers play computer games (they also eat meals and watch movies) but not at the expense of their hobby. The recent extraordinarily popular MMORPGs

[massively multiplayer on-line role- playing games] would not, I think, have trimmed a little from us at the edges had they been in direct competition, they would have wiped us out. Are our overheads killing us? Well, yes, they could have, but they don't stop us selling things. Is it a change in society? No. Demographics? No. World recession? No, no, no. It was us.

“We grew fat and lazy on the back of easy success. We forgot about customer service and forgot that hard work is and always has been the route to success. We forgot that we are a company which pursues profit and likes paying surplus cash to its owners.

What was not expected was that it would take two poor years and a management reorganisation to get the problems taken seriously. Somewhere along the line too many of us thought that selling, sweating and saving were someone else's job. Well they aren't. That's my job and the job of all of us here at Games Workshop.”

If the problems are self-inflicted, they are usually within the powers of the firm to fix. According to the Chairman the firm is “*seriously well-funded*” and this implies that free cash flow will be meaningfully in excess of net profits and will rise faster than revenues: all good then, for prospective profitability. Even so, the current valuation implies that the firm is worth little more than its investment in plant and equipment. To put it another way, like Air Asia, the market is saying that the company should not exist. We will leave it to the parents to break that news to their Warhammer-playing sons.

MBIA

The Municipal Bond Insurance Association (MBIA) is the largest bond insurance company in the world. Insurance is provided against the principal and interest payments of a bond in the event of non-payment by the bond issuer. The recent problem has been that when premium prices declined, the Municipal Bond Insurance Association did not stick to municipal bonds and began underwriting the losses of other types of credit, most notoriously bonds issued against, not the tax raising powers of a municipality, but the static value of securitized mortgages. Well, it has been a perfect disaster. We purchased shares after the firm took a sizeable write down on its equity value, raised capital twice, changed management and after new management bought shares themselves, and that has been a disaster too (as judged by the subsequent decline in the share price). Much of the debate has centered on the size of the credit losses, whether they are U\$2bn as indicated by the firm, or U\$6 to U\$8bn as indicated by some skeptics, or U\$13.6bn as implied by Moody's worst-case scenario, or greater than that as implied by the stock price discount to the firm's claims paying resources. There would appear to be considerable leverage to the upside considering the current market value, however we question our, indeed, anybody's, ability to so finely judge the losses on U\$680bn of insured assets. Both sides (longs and shorts) will think they are right, and it is perhaps the insecurity of their own positions that leads both to assert their cases so vocally in the media, at investment conferences and on the internet.

Whilst our interest was piqued by the stock's apparent discount to anything but the worst-case loss scenarios, in other words the odds looked attractive, the investment case from our perspective was somewhat different. The market value of the firm approximated the capital retained at the holding company and readily distributed from the insurance subsidiaries and attributes de-minimus value to the in-place insurance contracts written by the subsidiaries. The possibility exists therefore for a new insurance firm to be set up separate from the old. The old can be left in runoff with any eventual surpluses used to fund share repurchase at the

holding company or new business at a subsidiary level. So, at first blush there appear to be lots of options open to the firm, but to understand why we sold our MBIA, one must first discuss dilution risk.

Dilution Risk

Dilution risk occurs when companies issue equity at less than the firm is worth. This risk is always with us but is most pernicious at stock market troughs. Let's take a, not wholly, theoretical example: a firm is worth, under normal market conditions, say U\$2bn, divided by 60m shares or U\$33 per share. A value-oriented buyer may start to buy shares at around U\$15, thinking he has bought dollar bills for less than 50c. But what if the firm issues say, 30m new shares at U\$10 to fund U\$300m of cyclical losses. Under this scenario intrinsic value per share, adjusting for the U\$300m in losses, falls from U\$28 to U\$22. Purchases made at U\$15, thought to be at 47c on the dollar of value, turn out to have been made at 68c on the dollar. Worse still, dilution risk accelerates as the share price declines: if the firm raises the same amount of new capital (U\$300m) at U\$5 per share, then intrinsic value after the capital raising falls to U\$16 per share; and if capital is raised at a price of U\$1 per share then intrinsic value afterwards falls to U\$5.50. In the final example, original purchases made at U\$15, at what was thought to be less than half value, end up proving to have been made at three times intrinsic value! Investors can protect themselves from this risk by putting in their proportional share in any new capital raising. The problem comes when investors start to question the size of the capital raising. Perhaps the firm needs more than U\$300m? Is the business really worth U\$2bn? How can we know for sure? The doubt manifests itself in further share price declines and increases the dilution from not participating in a capital raising. Dilution risk comes from doubt about one's original analysis.

Short sellers know this and whilst it is tempting to criticize their widely circulated 150 page marketing documents (it is interesting that, in contrast, the longs tend to keep their best ideas to themselves), the shorts' regulated anonymity, their desire to keep the doubt going and create an outcome (i.e. share placing) what the shorts are really testing is the shareholders' conviction, and on this level, in our opinion, institutional holders also have much to answer. For example, dilution risk virtually disappears if large institutional shareholders backstop capital raising at reasonable prices. This would require a firmly held view of what a company is worth, shareholders and management that do not game the system (rarer than hen's teeth) and is best done, in our opinion, by way of rights (with rights not taken up underwritten by large holders). Take for example the arrangement between Assured Guaranty and Wilbur Ross. It appears that Ross has agreed to provide up to U\$750m to the company as, when and if the company requires. Management are free to raise capital elsewhere if they choose. In effect, Ross has gone a long way to under-writing the equity value (although not entirely) and for the time being the shares trade around book value. None of the other bond insurance companies, including MBIA, have this arrangement and all trade well below book.

The shorts know the institutions are weak minded. And the institutions themselves know they are weak. They are weak because, although equity is permanent capital, the owners of the equity are short term oriented. Institutional money managers appear to reason: why take a stand today when the shares could be half this price if I wait, and why buy shares today when I might get some shares in a placing at an even lower price? It is as if they suddenly do not know what a firm is worth. In taking such a timid view they sell their investments, themselves and their fellow shareholders down the river. Worse still, the preference in the United States for placings over right issues (gosh, the investment banks are good at marketing) means that

current shareholders can be cut out of the capital-raising loop entirely. Under this model of stock market participant behaviour the early contrarian buyer, who by himself is too small to influence the outcome by providing the capital required, is severely punished. So, however cheap MBIA may appear, the prospect of a future capital raising means that one cannot place a valuation on the business per share without knowing the number of shares outstanding, and we cannot know that until we know the size of the losses and the price of any future capital raising. In this Alice in Wonderland world, the stock's biggest attraction, its apparent cheapness, becomes the investor's Achilles heel, and it was for this reason that we sold our MBIA shares. And it is also for this reason that recent purchases by Nomad, which are not enough to recap businesses in their own right, and where there is meaningful dilution risk, have been modest in size.

So where have all the long-term investors that could be backstopping businesses gone? In our opinion, what we are witnessing is the effect of a generation or two of the ascendancy of the marketing people and risk managers in the investment management function. The business model at many firms is not to make investments, to research and provide permanent capital; instead, the business model is to gather and retain assets. Fund managers at such organizations may have a strong financial incentive not to stick their neck out, and instead wrap themselves in a grey cocoon of rented stock portfolios. In other words, the marketing guys have won. When I described this conclusion to one fund manager he replied "*but, dear boy, they always do*".

Duration

Tom Stoppard, the playwright, is credited with saying "*If an idea is worth having once, it's worth having twice*" and it is in this spirit that we will quote Jack Bogle's work again. Investment holding periods by institutional investors have declined from an average of seven years in the 1950s to less than a year by 2006, according to the Bogle Institute. Well, I am sure Jack and his colleagues are right, but we can't see it in our investments. The average holding period for the US stocks held in Nomad (excluding Berkshire Hathaway) is fifty-one days! That is approximately one twenty-fifth of the time that we expect to hold an investment. Those that set the current prices for our investments (the renters) cannot have an eye on long term value, and that, in a nutshell, is the investment case for Nomad.

And that raises an important point: the costs of short-termism, such as dilution risk, are borne by investors when management mark the share price to market and issue equity. In other words, it is borne early in Nomad's expected holding cycle. The gains from short-termism, such as our ability to purchase shares for meaningfully less than they are worth, will take far longer to materialize. In the example above, the buyer of 10% of the company at U\$15 a share and 10% of the capital raising at U\$1 per share would in the end see an overall profit of U\$80m on his U\$120m invested, even though his book loss at the time of the capital raising would be 93.4%! It is pain today and gain tomorrow. Our misanalysis of dilution risk at MBIA for example has cost Nomad investors about 1.5% of NAV this year, but the gains from our continued investment in Air Asia will, we expect, earn Nomad investors 20% of NAV in years to come.

Jack Bogle refers to his senior thesis at Princeton University regularly, even though it was written in 1951, and did so again in the following excerpt from a speech given to the Haas School of Business at the University of California in October 2006:

“Then, prophetically, Lord Keynes predicted that this trend would intensify as even ‘expert professionals, possessing judgment and knowledge beyond that of the average private investor, would be concerned, not with making superior long-term forecasts of the probable yield on an investment over its entire life, but with forecasting changes in the conventional valuation a short time ahead of the general public.’ As a result, Keynes warned, the stock market would become ‘a battle of wits to anticipate the basis of conventional valuation a few months hence rather than the prospective yield of an investment over a long term of years.’

“Simply put, what went wrong was a pathological mutation in capitalism—from traditional owners’ capitalism, where the rewards of investing went primarily to those who put up the capital and took the risks—to a new and virulent managers’ capitalism, where an excessive share of the rewards of capital investment went to corporate managers and financial intermediaries.”

Be that as it may, and although we are financial intermediaries ourselves, we don’t like it. One reason we don’t like it is we cannot for the life of us figure out why society at large is served by having company owners swap seats every few months? We all know it is pursued in the name of the efficient allocation of capital and liquidity, but it fails at the former and the latter is prized by the insecure. Has this reached an extreme? We do not know, but we did enjoy the following exchange between an analyst and the CEO of one of our investee firms recently:

Analyst: *“Was the exit [in terms of business performance] from March stronger or weaker than the entrance?”*

CEO: *“Sorry this is getting ridiculous, next question, please?”*

It is not our system. The point of equity is that it is the only permanent capital in the balance sheet. It is there to weather storms, such as the current economic backdrop, and provide a stable base, and of course to earn the rewards of enterprise. This basic building block of society is broken when those with their hands on the permanent capital change their minds with their underwear. It is no coincidence perhaps that pass-the-parcel and musical chairs are children’s games.

Charlie Munger described an alternative model at this year’s Wesco Financial annual general meeting. According to Munger the English establishment was so outraged by the speculation of the South Sea bubble and subsequent share price collapses, that in the early eighteenth century Parliament passed the Bubble Act, which outlawed the issuance of shares! That ban remained in place for over a century (1720 to 1825) and, it could be argued, during that century Britain set the stage for the Industrial Revolution, the greatest step forward in modern society. It is not clear we need to trade shares to be successful.

But trade shares we do. According to Empirical Research Partners, an independent investment research firm, the current period is the greatest momentum market since the dot com era, which was one of the greatest momentum markets on record. (A momentum market is one where the best performing stocks this month were those that did best last month and so on. It is unusual because rationally one would expect shares to become less attractive as prices rise.

However, currently investors chase stocks in order to own today what they should have owned yesterday. In effect prices rise just because they have already risen. Economics students will recognise this as a “Giffen good”).

It is unusual for investors to repeat the last mistake (dot com behavior) so soon. Psychologists argue that the last mistake is so vivid that, if anything, we tend to over- correct, as anyone with a whisky-hangover will tell you. The insanity of bubble-like valuations was well captured by Scott McNealy in a 2002 interview in Business Week when he was still CEO of Sun Microsystems (source: James Montier, Société Générale, Cross Asset Research Group),

“But two years ago we were selling at ten times revenues when we were at U\$64. At ten times revenues, to give you a ten-year payback, I have to pay you 100% of revenues for ten straight years in dividends. That assumes I can get that by my shareholders. That assumes I have zero cost of goods sold, which is very hard for a computer company. That assumes zero expenses, which is really hard with 39,000 employees. That assumes I pay no taxes, which is very hard. And that assumes you pay no taxes on your dividends, which is kind of illegal. And that assumes that, with zero R&D for the next ten years, I can maintain the current revenue run rate. Now, having done that, would any of you like to buy my stock at U\$64? Do you realize how ridiculous those basic assumptions are? You don’t need transparency. You don’t need footnotes. What were you thinking?”

More to the point, what do they continue to think? Why has, say, Potash Corporation of Saskatchewan, a miner of potash and manufacturer of fertilizer (share price up ten-fold in three years, to twelve times sales) taken over from Sun Microsystems, a manufacturer of servers (share price up ten-fold in the two years to 2000, peak valuation around ten times sales)? The answer, along with an unshakable belief in the sustainability and longevity of Chinese urbanization, emerging market demand, resource booms, search for inflation hedges and so on, may have something to do with the decline in investor time horizons – the average holding period for shares of Potash has declined from nearly two years to six weeks as the share price has risen, and if you own the shares for just six weeks, then what do you care if, in two years’ time, current prices turn out have been a bubble? Lord Keynes was spot on.

Rules, Roundabouts and IFRS 7

Even though the partnership has lost money so far this year, Zak and I have almost no stress from investing. All our stress comes from the business side of the operation: that is compliance, reporting, auditors, accounting and so on. Take for example IFRS 7, which requires directors to describe the risks embedded in their operation and how they manage those risks. At first blush this seems like motherhood and apple pie – who could argue with that? But let’s take Nomad. The risks the accountants are concerned with are, predominantly, interest rates, currency and credit risk, which is sensible enough. But then they ask, not how we manage these risks over the holding period of an investment (say selling foreign currency to match the expected five-year holding period of a foreign stock) but how these risks will be managed in the next 12 months! In effect the accounting rules ask how do we manage the risk that interest rates will rise in Thailand in 2008? On many of these issues, in the context of our investment time horizon, we don’t see the point. If interest rates do rise in Thailand in 2008, then the short term prospects for our shopping mall, Mah Boon Krong Holdings, may temporarily decline, but it is far from clear that that event is a risk to business value in five years’ time. Indeed, it looks like an opportunity to us! In other words, the accounting tries to bend Nomad out of shape. So all is clear, Zak and I see our job as controlling the risk of mis-

analysis of the big things – value per share of an investment many years out – not spotting wiggles on the path along the way. Everyone else does wiggle guessing. Whilst we respect the intentions behind the rules, and our candid response is contained in note 4 of Nomad’s accounts, one is left feeling the exercise has been nothing but a tax on time: a cost disproportionately borne by small investment firms; a barrier to entry. It is partly through dealing with IFRS7 that the Nomad audit was completed at the end of June rather than earlier in the year.

In previous letters we have described the events that surrounded the flood in Carlisle, England a few years ago. Readers that make it to the end of our letters (there must be some) may remember that after the flood the main traffic lights on a busy two roundabout junction (grief, one roundabout on top of the other!) had failed, and that despite this, the police had allowed the traffic through, only for the town planners to discover that, months later, and with the lights still not working, the intersection was safer despite higher average traffic speeds compared to before the flood. One can imagine how we cheered at a recent newspaper article, which reported that the Dutch town of Drachten had borrowed a leaf from Carlisle’s book, and removed most of their traffic signals. The project was the brainchild of Hans Monderman, a traffic planner who claimed in an interview that *“it works well because it is dangerous, which is exactly what we want. It shifts the emphasis away from the Government taking the risk, to the driver being responsible for his or her own risk”*. Bravo, sir!

Should readers think that England is at the forefront of such open-minded initiatives please observe the efforts of workmen in Coventry, England who recently built a roundabout and placed “no-exit” signs before every exit, with the effect that once drivers entered the roundabout, there was no way off! The non-thought of those following orders never ceases to amaze. There are two routes to follow in investing: Drachten or Coventry. And we are following Drachten. The future is uncertain, nothing is perfect, and Zak and I may make huge mistakes. And it is because of this risk that Nomad will operate at its best.

Momentum Investing Revisited

In December last year the contents of the Savoy Hotel in London were auctioned to the public. There were several interesting lots: silver trays, pepper and salt pots stamped with the hotel’s insignia and so on, although one that caught my eye was a chrome wall protector in the shape of an ‘S’. ‘S’ for Savoy, ‘S’ for Sleep (such vanity – first mistake), and well, I have always had a soft spot for the hotel (second mistake) and whilst I had no idea what the intrinsic value of such an item might be (third mistake), I placed a bid (fourth mistake). There were a dozen ‘S’s for sale with lots available over three days. On the first day the prices rose from £350 to £500. On the second day they started down a little at £400 but rose to £800. And on the final day they started at £600 and rose to £850. Notice that the lowest price of each day was the first price and how prices rose steadily throughout the three days. Why? The answer, it seems to us, is first, scarcity, as the auction continued the stock of available ‘S’s declined. Second, social proof, once one person had set a high price it was seen by others to endorse the value of the item and they too could pay a higher price knowing they were not alone. And what price did your author pay? Well, let’s just say I bought on the last day...and I justified it by telling myself that it was a one off, the Savoy is special, I won’t get this chance again, ‘S’ for Savoy, ‘S’ for Sleep, and so on. And I just know I overpaid (Mrs. Sleep’s withering what-have-you-done-now-look said it all). We can all do momentum investing, but it is emotional investing and I just don’t think it is that intelligent, or profitable.

Current performance notwithstanding, Nomad is in good health, despite our “senior moment” in mis-analysing dilution risk (Zak and my aggregate age is, after all, 79!) Almost ninety percent of the portfolio is invested in firms run by founders or the largest shareholder, and their average investment in the firms they run is just over twenty percent of the shares outstanding. Fifty-five percent of portfolio companies are either repurchasing shares or have had meaningful insider buying. There is huge growth embedded in the portfolio and normalized profitability is high. Despite these attractive prospects the average investor rents shares in our firms for fifty-one days. They simply cannot be looking at what we are looking at. Our shares are cheap because investors prefer to chase the new booms surrounding Chinese urbanization and associated natural resources demand. We have no idea whether purchases of resource stocks at current prices will prove profitable for these investors. However, we do know that our stocks are selling at bargain prices. Since September 2001 the Nomad share price has risen from US\$1000 to around US\$3000 today. Zak and I see our job as getting it to US\$10,000 in time, and the current portfolio should get us substantially there.

There are times when it is easy to feel good about investing, and there are times when it is much harder. The emotions usually go with outputs. After Nomad’s share price tripled, it was easy to feel that God was in heaven but, as prices decline, spirits sag. We would counsel you to think about the inputs to investing rather than the outputs. It is in times like these that the hard psychological and analytical work is done and the partnership is filled with future capital gains: this is our input. The output will come in time. Those with a rational disposition may not find it too hard to feel good today.

As always, we thank you for your confidence in us, and most of all, we value your quiet patience.

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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