October 9, 2001

Enclosed are your statements for the third quarter of 2001.

For the quarter, equity investors saw returns of -14.7% for the S&P 500, -15.4% for the Dow Jones Industrial Average (DJIA) and -30.6% for the technology-oriented NASDAQ. These negative returns were driven by investor concern over reduced earnings prior to September 11 and a "new era of terrorism" after that date. For the last twelve months, equity investors saw returns of -26.6% for the S&P 500, -15.5% for the DJIA and -59.1% for the NASDAQ.

Again, a review of portfolio math is relevant due to the extreme returns of recent history. Portfolio returns are geometric and not arithmetic, meaning they don't add up. For example, if a portfolio is up 50% one year and down 50% the following year, the portfolio, surprisingly, does not break even. Instead the portfolio is down by 25%. To break even after the last twelve months' NASDAQ return, a NASDAQ portfolio needs to increase by over 140%! Investors waiting to break even are bound to be disappointed.

For the quarter, fixed income investors saw returns of 3.39% for the 1-3 year Treasury Index, 6.78% for the 7-10 year Treasury Index and 6.76% for the 10+ year Treasury Index. These returns were created by the increased liquidity provided by the Fed, as rates were reduced two times for a total of 75 basis points or 0.75%. Year to date, the Fed has dropped rates by 350 basis points or 3.50%. In line with such increased liquidity, one might expect lower quality corporate bonds to do well. However, for the quarter, 10 year BB- corporate bonds saw returns of -1.78%, reflecting the poor lending decisions in last year's euphoria. As we commented before: "liquidity is up and profits are down; the bubble has popped and the aftereffects remain."

The events of the last month have been shocking and disheartening. Yet any student of history would tell us that even more shocking has been the absence of such events for a long time. Pax Americana has been impressive, but has been fully priced into the stock market. We have been and continue to be wary of these lofty prices. As Warren Buffett commented, "when the tide goes out, you know who has been swimming naked."

We have repeatedly stated that we prefer to see the stock prices of most of the companies in your portfolio go down. While we are pleased with the purchases we have made, we could further increase our long-term returns with better buying opportunities. Most investors look for buying at the "bottom." We are simply looking for outstanding investment opportunities, regardless of short-term price movements.

Unfortunately, with one exception, the problems in the stock market have not spread to the stocks of companies in your portfolio because the companies in your portfolio are viewed favorably. The one exception has been Cendant, an outstanding company with business in the travel and lodging industry. We hope that current stock owners continue to reduce their ownership. We are happy to increase ours at the right price. As said before, your portfolio's good performance this year has been a mixed blessing. This performance is good for short-term wealth creation and the moods of our clients. Yet, long-term wealth is created by low prices so that we can increase your ownership in these stocks. Long-term wealth creation is what we aim for.

The tragedies of the past quarter did present investment opportunities. As the stock market opened after the disruption, it promptly fell to new lows. We found opportunities that we had waited for and purchased initial allocations of American Express and The Walt Disney Co. We hope to purchase more at lower prices so we ask you to tell your friends what awful companies these are. As we stated before, "the thought of purchasing such companies at mathematically sound levels is almost breathtaking."

In order to be prepared for such opportunities, we do have to hold some cash in your portfolio. This causes us as much joy as it does you. We realize that you do not pay us to hold cash. However, to act quickly as we did in mid-September, we must have cash on hand. Warren Buffett once commented that it was no fun having cash burn a hole in his pocket, but it was much more fun than having that cash burn a hole in someone else's pocket.

We will continue a patient, but attentive search for the purchase of excellent companies at prices significantly under their intrinsic value. As always, we appreciate the stewardship responsibilities you entrust to us.

Academy Capital Management