July 11, 2002

Enclosed are your statements for the second quarter of 2002.

For the quarter, equity investors saw returns of -13.4% for the S&P 500, -10.72% for the Dow Jones Industrial Average (DJIA) and -20.63% for the technology-oriented NASDAQ. These negative returns seem driven by investor anxiety over accounting issues, corporate governance and market valuation. For the last twelve months, equity investors saw returns of -17.99% for the S&P 500, -10.31% for the DJIA and -32.07% for the NASDAQ.

We pay attention to these benchmarks, the S&P 500 in particular. In his recent annual report, Warren Buffett stated that "owning the S&P 500 will produce reasonably satisfactory results over time." An important reason for our employment is to provide you with advantages over those results. In the quarter just ended, we have.

For the quarter, fixed income investors saw returns of 1.24% for the 1 year Treasury Index, 3.79 % for the 5 year Treasury Index, and 3.91% for the 10 year Treasury Index. These returns seem driven by the investors seeking safety in bonds. In line with such increased anxiety, 10 year BB- corporate bonds saw returns of -7.94%. The Treasury Inflation Protection Securities (TIPS) we have emphasized continue to be an outstanding choice for fixed income investments.

Today, the most striking aspect of the market is "hope." Present for several years and now absent, we noticed "irrational expectations." The difference between the two is worth noting. Based on the faulty assumption that a "new era" had begun, investors developed expectations that were thought through and acted on. Hope does neither, but waits fearfully. Discussions of "recovery" have little of the conviction that the "new era" did. The movement from "expectations" to "hope" has preceded our own worst investing moments and in the current market we don't expect the outcome will be different for others.

In reviewing your statement, you might notice some departures from our recent practice. For the first time since 1998, we have sold a number of stocks. Our preference is **to hold a stock indefinitely** and let the long-term ownership of great companies build your net worth without paying capital gains taxes along the way. Yet, we sold American Express, Disney, Landstar and Sigma-Aldrich during the past quarter. Further, we have reduced some of our smaller positions. Why are we doing this?

In owning a stock, the most critical factors are not general economic or market conditions; rather, they are the quality of the business and the price of the business. Over time, high quality companies command a high price and low quality companies trade at low prices. These patterns cause investors to ascribe business quality to business price. That is a mistake. Most companies have wide annual volatility of prices while few companies have wide annual volatility of quality. We invest when the prices of high quality companies are lower than appropriate. This happens regularly, but it does not happen every day and so we are loathe to sell our position at a short-term trading profit. We like to hold out for the long-term business-owning profit.

With American Express and Disney, our declining convictions about their quality met with the rising price of their stock to force a sale. We made money, although not as much or for as long as we had originally expected. With Landstar and Sigma-Aldrich, our unchanged convictions of their quality were met with a rapidly rising price to force a sale. If operational improvement of both companies had been in line with price behavior, we would have preferred to keep them. As it was, we made good money in line with our expectations.

Another departure reflected in your statement is the acquisition of a group of pharmaceutical stocks. Some companies **and** some industries have investment advantages. In late 1999 and early 2000, we purchased four insurance companies. Insurance is a business that we like, although we don't like the industry. Periodically, the prices of insurance companies get cheap when the inferior companies price so aggressively that all companies begin to do poorly. So, the worst plan is to buy the cheapest insurance companies but it is almost as bad to buy the insurance industry. The strategy we employed of buying the best companies in the industry has paid off handsomely, and we expect it to continue to do so.

In the case of the pharmaceutical business, we like the industry even more than we like the individual companies, whose fortunes depend on unknowable factors like their ability to get drugs approved. Periodically, the prices of drug companies get cheap collectively, but not through brutal industry competition. That is the most striking aspect. In most industries, such as insurance, industry competition periodically depresses profits. The real pressure on drug profits comes from outside the industry - from the political process, for instance. With attractive industry characteristics and the difficulty of company comparison, we believe the strategy of buying the industry through a "basket" of companies is best. As a result, we will be purchasing more companies in this industry (12) than is typical for us (4), but in smaller allocations (.5%) than is normal (1.5%). We are excited about the opportunity. 1993 was the last time we found "rational" pricing in this industry, but it is returning now.

The performance this quarter has been ideal. Your bonds, which are a source of investment cash, rose considerably, while a number of your stocks declined. As we have mentioned before, long-term wealth is created by low prices so that we can increase your ownership in these stocks. Lower prices are only a problem if you have run out of "dry powder." Lower prices are wonderful if portfolios have cash and we have lots of it. So we prefer to see the stock prices of some of the companies in your portfolio go down.

You may wonder why we would not want these stocks to go up while stocks not in the portfolio go down. Here it is. Most of the companies in your portfolio are the best in their industry and, just as important, we have worked hard to get to know them well. We would rather own a short list of such knowns than a long list of guesses. While we are pleased with the purchases we have made, we can increase your wealth with better buying opportunities. Long-term wealth creation is what we aim for, not buying at the "bottom."

As we've stated before, but it bears repeating, 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, 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 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