April 11, 2003

Enclosed are your statements for the first quarter of 2003.

For the quarter, equity investors saw returns of -3.15% for the S&P 500, -3.64% for the Dow Jones Industrial Average (DJIA) and 0.58% for the technology-oriented NASDAQ. These returns may have been driven by investor ambivalence over new government strategies such as pre-emptive war. The Federal Reserve maintained interest rates, continuing an "easy money" environment. Further, the federal government demonstrated a willingness to support the economy by increased deficit spending, but state and local governments are facing severe budget constraints. The aftermath of the bubble continues. Since the beginning of 1999, equity investors have seen annualized returns of -7.09% for the S&P 500, -1.47% for the DJIA and -10.64% for the NASDAQ. For the same period, equity-based investors of Academy have seen annualized returns of 6.28%.

As stated before, we believe that over long periods of time, ownership of the S&P 500 will provide a rate of gain in intrinsic business value reflecting the U.S. economy. Such returns are reasonable, even if much lower than desired. Our goal, and an important reason for our employment, is to provide you with a higher rate of return through increases in the value of businesses held in your portfolio. For this reason, we are including not only shorter measures of performance of the S&P 500, but longer ones as well.

For the quarter, fixed income investors saw returns of 0.44% for the 1-year Treasury Index, 0.94% for the 5-year Treasury Index, and 1.03% for the 10-year Treasury Index. These returns closely align with the actual coupons of the bonds. This alignment mean there was little change in policy or expectations. One of the apparent reasons for the Federal Reserve to keep rates low is so corporations may repair their damaged balance sheets. It is no coincidence that investors were encouraged to take balance sheet risk and drive 10-year BB- corporate bonds up by 5.47%.

With this reflationary activity, we continue to hold Treasury Inflation Protection Securities (TIPS) as an outstanding choice for fixed income investments, but, as stated last quarter, are no longer buying them. It is worth reflecting on our change. When we bought these bonds in 1999, we were excited by the U.S. Government guarantee, the protection from inflation and the nearly 4% real return. To us, these qualities were highly desirable and the price was right. To others at that time, protection of principal and protection from inflation seemed unnecessary. Those really were the good old days. We continue to hold that both protections are increasingly important, but because this opinion is widely held, the price is no longer right. Unless **both** high quality and good price are available, we don't get involved.

But nervousness in the stock market did allow for a few excellent investment opportunities during the past quarter. We have long admired the American International

Group (AIG), among the largest insurance companies in the world, capably led by Hank Greenberg. As long-term clients know, we like the property and casualty insurance business, and AIG is one of the best. During the past quarter, AIG announced problems with its director's liability insurance line. The resulting nervous selling finally made the price of AIG affordable. We bought twice.

The price of Home Depot's shares provided us with another such opportunity. In today's difficult business environment, we have strenuously avoided retail businesses. However, we do look for business models where "toll bridge" opportunities exist. As Home Depot's share price dropped precipitously, we were surprised to find that investors believed that the threat of Lowe's was overpowering. Lowe's and Home Depot have both developed an excellent business model with high returns on capital and a "top of the food chain" positioning. The decline in Home Depot's share price was disappointingly mild. We were only able to buy once.

We view the business environment as particularly difficult. In a nutshell, it is too competitive. With so many providers, businesses cannot raise prices even though raw costs are going up. As a result, the viable growth rate in both revenues and earnings is low relative to the expected growth rate. As we review companies, a pattern of extremely slow growth on existing business is evident. Any growth is likely to be a function of acquisitions at high prices followed by drastic cost cutting. The result is an appearance of growth, but is actually simply merging two companies who are not growing to create the illusion of growth. This process will come to an end, and the multiples of earnings could contract significantly, despite U.S. Government and Federal Reserve supports.

We have rarely found that relying on a government's support of price levels is reliable. Ultimately, price levels arrive at mathematically sound and sustainable levels. With such currently high prices in TIPS and quality businesses, you will notice a continuing high level of cash. As Warren Buffett wrote in his last annual report (highly recommended reading), "sometimes good investing requires inactivity." This does not mean, however, that we are idle (as some thought as we sat through 1999). Rather, we continue out patient and 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