October 09, 2003

Enclosed are your statements for the third quarter of 2003.

For the quarter, equity investors saw total returns of 2.65% for the S&P 500, 3.79% for the Dow Jones Industrial Average and 10.22% for the technology-oriented NASDAQ. Since the beginning of 1999, equity investors have seen annualized returns of -2.97% for the S&P 500, 2.07% for the Dow and -3.90% for the NASDAQ. For the same period, equity-based investors of Academy have seen annualized returns of 8.46%.

For the quarter, fixed income investors saw returns of 0.31% for the 1-year Treasury Index, -0.41% for the 5-year Treasury Index, and -1.81% for the 10-year Treasury Index. The riskier 10-year BB- corporate bonds were driven up by 1.65%.

During the past quarter, we have made some adjustments in our stock and bond positions. However, these adjustments are in line with discussions in prior quarterly letters. So we will reserve this quarterly letter to address a frequently posed question - "how much money can I spend from my stock portfolio?"

For our clients, it is much easier to answer the question, "how much money can I spend from my bond portfolio?" Bond owners receive an annual amount of interest from the bond and then receive their principal at maturity. As long as the bond owner does not spend more than the interest paid per year, the capital remains intact and may be passed to the next generation. (In the spirit of "whatsoever is good…think on these things," we will avoid the evils of default, war, income and estate taxes for this entire discussion.)

The shareholder's version of this approach, spending only dividends, is not reasonable. Most companies pay out a small part of their incomes as dividends, choosing instead to retain their earnings to build further business value. Such companies function like those unusual bonds: Treasury Inflation Protection Securities (TIPS). A TIPS bond pays out a low coupon payment, while the bond increases in value for inflation. So, the coupon payment of these bonds, like the typical stock dividend, is not a good measure of the full income of the bond.

Intuitively recognizing this, most shareholders have not limited spending to their dividends. But, in setting their spending by reference to the market appreciation of their stock portfolios, they have moved from the poor standard of dividends to the disastrous standard of market movements. Let us return to the example of bonds to understand why market valuation spending is so perilous.

If a typical bond is purchased for $100,000 and pays a 5% coupon for 10 years, the bond owner knows that the income will be $5,000 per year. As long as the bond owner does not spend more than $5,000 per year, then the capital will remain intact and be returned at the end of year 10. If during this period interest rates move down, the value of the bond will rise. If interest rates decline to 3%, the bond could increase in value by over $17,000. While this will make bond owners happy, very few of them would view that increase as an opportunity to spend $22,000 (the combined value of the coupon and the appreciation of the bond). Yet, that is precisely what many shareholders do when they see a rise in stock values.

When we purchase a stock for you, we are purchasing a fractional ownership of a wonderful business. Over time, the earnings of the business and what is done with them determine the true value of the investment. Dividends provide no such guidance. Over time (always the tricky phrase in investing), the market value should reflect the ability of the company to generate earnings. But most of the time, it doesn't. Caught up in short term information, market values often ignore earnings. But it is these underlying earnings that we think should be the fundamental basis for the shareholders' spending decisions, because, like the payment from a bond, they can be sustained without eroding the value of the business. The question is how to determine what they are.

Dividends are not subject to debate. They are either paid or not. They are in the form of cash or stock and very specific. Earnings, on the other hand, are the result of accounting rules applied to complex business situations. As we have all seen, sometimes these results are highly misleading. The accounting industry stays in a continual process of attempting to tie those results to underlying reality. Often politics intervene and businesses are allowed to "cheat" on their scorecard, as in the case with stock option expensing. So, even accounting results are imprecise.

A further level of uncertainty exists about the sustainability of earnings reported. Some earnings are filled with "one-time events." Some companies have a "one-time event" annually. Many of the companies in the food industry have this issue. At Academy, we are forced to do our own calculations and estimates of the regularly recurring earnings so as not to be misled by "one time events" that may be part of an underlying cost issue.

Finally, all earnings are not alike in value, even if they are identical in amount. Some businesses require the reinvestment of earnings, and some do not. There is no accounting for this distinction. We much prefer to own businesses which do not, for competitive reasons, require the reinvestment of earnings and whose earnings are truly available for shareholders, even if the business chooses not to pay them out. We have therefore created a concept of "intrinsic income" to designate the regularly recurring earnings stream that is truly allocatable by the management to either dividends, stock repurchases, acquisition or for reinvestment in the business.

For a couple years, we have been providing an alternate appraisal format equipped with such earnings figures on the Academy website for your use. This format is our way of introducing the concept of your "pro-rata share of earnings." As mentioned earlier, these "pro-rata" earnings are imprecise. But, we do not believe that our inability to quantify these precisely should mean that we ignore them. Rather, these statements are provided under the rule that "it's better to be generally correct than precisely wrong."

On this alternate format, you will find that we have termed these "pro-rata earnings" as "intrinsic income." The sum of the "intrinsic income" column is our estimate of the amount of income that your investments really generate for your stock portfolio. If there is any number on which to base your spending, this number most closely approximates it. It is important to remember that this is a pre-tax number, so you should adjust your spending accordingly.

As always, we appreciate the stewardship responsibilities you entrust to us.

Academy Capital Management