January 12, 2004

Enclosed are your statements for the fourth quarter of 2003.

For the quarter, equity investors saw total returns of 12.18% for the S&P 500, 13.4% for the Dow Jones Industrial Average and 12.3% for the technology-oriented NASDAQ. Since the beginning of 1999, equity investors have seen annualized returns of -0.57% for the S&P 500, 4.56% for the Dow and -1.45% for the NASDAQ. For the same period, equity-based investors of Academy have seen annualized returns of 9.31%.

For the quarter, fixed income investors saw returns of 0.28% for the 1-year Treasury Index, -0.67% for the 5-year Treasury Index, and -1.29% for the 10-year Treasury Index. The riskier 10-year BB- corporate bonds were driven up by 5.39%.

Such risk-oriented returns in the midst of a difficult business environment remind us of a recent plane trip out of the mountainous Aspen airport. As the pilot was twisting and turning the plane through the mountains and the white-knuckled adults were holding their breath, one little girl yelled out "flip it, flip it over!" (She'll probably be a great hedge fund manager someday.)

Generally we do not discuss the "stock market," but would rather pay attention to individual companies. Yet the stock market returns in 2003 deserve study for their apparent perversity (like 1999). Stocks that started the year at a price less than $10 per share appreciated more than 50%, while stocks priced at more than $50 per share appreciated less than 12%. The stocks of companies that had irregular earnings, a low return on equity, high capital expenditures and no dividend appreciated by greater than 70%! But stocks of companies with steady earnings, a high return on equity, low capital expenditures and a dividend rose less than 10%. Stocks of companies that did not expense stock options had twice the appreciation of companies that did the right thing and expensed stock options.

There are some rational reasons for such returns. In a recession, investors tend to take money out of risky investments in a flight to safety. The movement of money to safety only makes a recession worse. The Fed's response is to lower cash returns to rekindle the "animal spirits" of investors and encourage risk-taking behaviors, causing a flight **from** safety. As a result, "junk" bonds outperform safe bonds and "junk" stocks outperform safe stocks. 2003 was a classic case of the Fed's mechanisms at work. So why didn't we lower our investment standards and buy stocks with "junk" status or at least pay more for the stocks we favor?

The best way to make money is to compound it positively. Superior investment results are more a function of avoiding dumb decisions than making brilliant decisions. Some are arguing that if we are coming out of a recession but interest rates are staying low, then we should consider "paying up" for stocks. But, our view is that if we are dealing with a bubble, then the environment warrants even higher than normal caution. So, are there signs of speculative behavior? We believe so and will articulate that case briefly.

While we stated in an earlier letter that bubble conditions were abating, the market never really hit a low point, even though there were painful losses in individual stocks and sectors. At its lowest point in 2002, the average of the stocks in the S&P was still 25% above their long term average using traditional measures. Moreover, leadership has returned to NASDAQ stocks, where the original "bubble" occurred. In a normal post recession recovery, we would expect leadership to change. In addition, NASDAQ margin is at new highs, cash is at lows and investor confidence is at 1999 highs. Unlike the prior bear market from 1973-74, volume never decreased, but increased steadily. Further indications are the increases in the NASDAQ/NYSE volume ratio and IPO activity. In light of the collapse in speculative activity in 2000-02, those increases seem to reflect a reflex bounce in the extremely depressed technology sector rather than appear to be the start of a new, long-lasting upsurge.

Looking abroad we see further speculative evidences. The *Hong Kong Financial Market Weekly* reported "There's no early cooling of IPO fever…indeed, it intensified last week, as retail investors rushed to apply for the new shares of Great Wall Automobile (Not Rated) and Fujian Zijin Mining (Not Rated)…Great Wall was 683x oversubscribed, while for Fujian the market response was so overwhelming that there was even a shortage of application forms (after the first 1.2 million were snapped up in a few hours, another 1.3 million had to be printed)…thus, many applicants are likely to be disappointed…yet, the persistent spectacular performance of new shares is likely to keep retail investors hopeful for quick profits — the PICC Property & Casualty (Not Rated) IPO became a legend following an 80% gain in five weeks, as Chia Hsin Cement (Not Rated) soared 47% on its December 11 debut, and Great Wall Auto shot up 65% on day one." Sound familiar?

Most importantly, the Fed is doing its job very well. By enlivening "animal spirits," the Fed is reflating assets in what remains, we repeat, a troubling, excess-capacity deflationary environment. These are critical times. If the Fed fails, serious problems of credit implosion could occur. (As eager as we are for good investment opportunities, we would not truly wish for such an outcome.) But, even if the Fed succeeds, as it appears to be doing, Jeffrey deGraaf of Lehman Brothers makes a worthwhile observation. "While stock bulls view reflation as the answer, secular bull markets in equities have **never** existed while hard assets outperform financial assets." Despite the returns of 2003, this is, at best, a difficult environment.

The heart of our investment approach is the study of individual companies. While in the present pricey environment, compelling opportunities are rare, but we are seeing an extraordinarily fine company selling at a major discount to intrinsic value. Johnson and Johnson is a company that we have often analyzed, but never truly hoped to own (short of a depression.) Yet, its share price continues to flounder at value level. These are moments at Academy similar to those of a fisherman feeling a powerful tug on his fishing line. Here is a comment from the latest annual report, "In fact, the last time we did not achieve year on year sales growth was in **1931**, (bold added) during the Great Depression." The company has over 200 business units, none of which are forced to operate in a "synergistic" (bad word in our lexicon) fashion. Each unit is there to generate profits for the shareholder. We applaud their business lines, their management approach and their shareholder orientation and are increasing our ownership.

As a result of the infrequency of such opportunities in today's environment, we have sizeable cash positions, particularly in new accounts. Seth Klarman, an outstanding money manager, in essay in Grant's Interest Rate Observer (Oct. 10,2003) argued that "the (investment) opportunity set available today is not the complete opportunity set that should be considered."   Future opportunities must also be considered. The cash in your account represents the current scarcity of compelling investment opportunities and the belief that the future will offer superior opportunities to purchase at more reasonable prices that those today. We are confident that even if bubble conditions persist, there will be individual opportunities like the one we have seen with Johnson and Johnson. And, we continue our patient and attentive search for them.

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

Academy Capital Management