October 5, 2009

Enclosed is your statement for the third quarter of 2009.

For the quarter, equity investors saw total returns of 15.61% for the S&P 500, 15.82% for the Dow Jones Industrial Average and 15.91% for the technology-oriented NASDAQ. For the quarter, fixed income investors saw total returns of 0.38% for the 1-year Treasury Index, 2.03% for the 5-year Treasury Index, and 2.65% for the 10-year Treasury Index and the 10-year BB- corporate bonds had total returns of 8.64%. The quarter presented equity and fixed income investors with a vigorous recovery in prices as stronger segments in the credit markets resumed normal activity. But, for the weaker segments, deleveraging continues and credit is, for the most part, highly restricted. In many ways, we do not see a new pattern here, but only a return to the pre-21st century practice of lending to those who don't need loans.

The striking increases in prices during the past quarter caused us to reverse the activities of the past two quarters. As the markets collapsed, starting in September 2008, we purchased additional shares of companies we owned. By the end of February 2009, we had nearly invested all of our cash position, reaching our most fully invested status in over a decade. Since then, the markets have staged a spectacular recovery and we have responded in two ways: 1) we raised our cash position by trimming the positions of stocks whose prices rose most aggressively and 2) we used some of the cash to expand into shares of companies which we had never owned. This quarter's letter will address both responses, reflecting on how these reallocating actions reveal as much about our price-value orientation as the purchasing actions did in prior quarters.

Throughout this economic crisis, we have been asked what we thought would happen. We do not consider our standard answer of "We don't know" to be embarrassing or the product of mushy thought. Rather, we think that agnosticism about the future puts us on a more secure footing. With a clear understanding of what we can't know, we can more effectively direct our attention to what we can know: the purchase of great investments at good prices. In this pursuit, we select opportunistically from the universe of stocks and bonds.

As we have written before, navigating that universe of stocks and bonds involves two all-important numbers: one representing price and one representing value. Price is visible, precise and volatile; value is hidden, general and stable. Given our human tendencies towards the visible and precise, we all too naturally attend to price. It is like the story a client shared with us – as a child, he received this advice from a local store owner, "Son, just remember: everyone knows the price, but few know the value."

Our goal is to determine the value. When prices change, we compare them to our evolving estimates of intrinsic values. During the past year, almost all stocks experienced a decline in price. As we compared value to price, we were excited by the opportunities presented. It seemed to us that many of these stock declines occurred even while the intrinsic value of the company was increasing. Moreover, even in those instances where we saw a modest decline in intrinsic value, the drop in stock prices was so dramatic that we purchased more stock. But in some of those cases, as prices, particularly in the financial sector, rise in an equally dramatic way, we are trimming our positions, because of the continuing, but gradual decline in intrinsic value.

On the other hand, many of our companies have increased in their intrinsic value. Observing these patterns has helped us identify other companies which we have also seen increase their intrinsic value. With the cash raised from the process described above and helped by the fire-sale prices of this market, we have been able to add new companies to our portfolio. Of particular note is our expansion into international investing. We had always believed that we could find enough challenges investing domestically and did not need to go overseas to find more! Accounting differences, cultural opaqueness and currency problems were just the starters for seemingly insurmountable obstacles to international investing.

So what has changed? Over time, we have continued to reevaluate prospects for growth. The U.S. economy is a powerhouse, evolving from manufacturing to services to finance. Undoubtedly, our economy will continue to innovate, but in the absence of credit expansion, growth rates will slow dramatically. Overseas markets continue to extend credit from domestic savings as a means of expanding their economies. In addition, the world is becoming a smaller place as this crisis has impelled movement towards international accounting standards and regulation. Globalization combined with higher overseas growth rates and low prices have combined to overcome our historical reluctance to invest internationally.

We hope this letter helps you increase your understanding of our approach. We want you to stay informed and feel comfortable about our investing discipline. If you're new to Academy, past quarterly letters may be useful and may be obtained through your financial advisor or Sue Compton at our office. In addition, our website (at www.academycapitalmgmt.com) has our investment reports on the individual holdings in your portfolio.

As always, we appreciate the stewardship responsibilities you entrust to us and your patience with our investment process.

Academy Capital Management