January 7, 2010

Enclosed is your statement for the fourth quarter of 2009.

For the quarter, equity investors saw total returns of 6.04% for the S&P 500, 8.10% for the Dow Jones Industrial Average and 7.20% for the technology-oriented NASDAQ. For the quarter, fixed income investors saw total returns of 0.11% for the 1-year Treasury Index, -0.59% for the 5-year Treasury Index, and -3.62% for the 10-year Treasury Index and the 10-year BB- corporate bonds had total returns of 4.44%. During the quarter, prices of "risk" assets rose, as investors exhibited confidence that the worst was behind them. As a result, "risk-free" assets, like U.S. Government bonds which so popular a year ago, were sold and dropped in value. Seasons change.

Our fourth quarter letter tradition is to discuss the investments which have generated the best results for the year. Reviewing investment gains is not only pleasurable, but also can increase understanding of our investment processes and principles. In 2009, our lead gainer both in percentage gain (over 126%) and total dollar gain was the stock of American Express (AXP). AXP's business exceeded general expectations by combining a radical downsizing of its credit card business with aggressive marketing to merchants. AXP is an impressive company. As we all know, 2008 was a horrendous year for financial companies. Yet at the end of 2008, AXP was still voted the "most trusted" brand in the U.S., not simply in finance, but including every category.

But we're not doing handsprings (yet) because the long-term results for our ownership of AXP are much lower than 2009's lofty returns. That's because AXP was tied for our "worst" investment in 2008 when the stock was down 67%. (We put quotes around "worst" because, as long time clients know, lower prices give us opportunities to increase our ownership, which we did in AXP.) Though it might seem that summersaults are in order because a plus 126% in 2009 wildly trumps a negative 67% in 2008, it doesn't work that way.

The math of money is not like the math of everything else. While it's true that "the whole world ain't nothin' but a numbers business," there are actually two kinds of number businesses. Day to day, most of us use the arithmetic kind of numbers business. If I give away 67 apples and then later receive 126 apples, I will have 59 more apples than I started with. Sounds like our investment returns should do the same thing. But, unlike our arithmetic apples, "money doesn't grow on trees." Instead money grows in a geometric way, which is very different than arithmetic.

Arithmetic comes from a Greek word meaning "numbers," that is, measuring units. Geometric comes from a Greek word meaning "earth," that is measuring space or volume. With arithmetic, the numbers are independent while geometric measurement has a relationship to what's around it. My giving away 67 apples does not affect the 126 apples I receive. But, in the case of AXP, my 67% down affects how much will go up by 126%. This is the geometric process. As a result, the 67% down drives $100,000 down to $33,000. In the following year, the investor would require a 200% gain just to break even! 126% isn't enough, only bringing the $33,000 up to $74,500. Even if the order of returns were changed, the outcome would be the same. A 126% increase would cause $100,000 to grow to $224,000, but the 67% drop causes it to go to the same $74,500.

This real life example not only illustrates the outsize impact of losses (the S&P 500 results table above provides another such illustration), but also the importance of purchasing more shares at lower prices when they become available. In order to achieve positive investment results in a world prone to instability and shocks, an investor must be prepared to capitalize on events. After all, that is the essence of capitalism – to capitalize on anything, especially problems. In the case of AXP, we did purchase more shares as the stock dropped in 2008. Then, in 2009, we trimmed some of our shares as the price rose sharply. These investment decisions are based on a respect for powerful effects of geometric math.

As a side note, an excellent authorized biography of Warren Buffett is available titled "The Snowball" by Alice Schroeder. This letter's discussion should shed light on why such a strange title was chosen. Here are a couple of sentences from the book that describe the essence of geometric math as conceived by the amazing 11 year-old mind of Warren Buffett: "The way that numbers exploded as they grew at a constant rate over time was how a small sum could turn into a fortune. He could picture the numbers compounding as vividly as the way a snowball grew." Warren understood why the Greeks based this math on "earth" measurement – just like his snowball.

We hope this helps to show why we at Academy are accused of acting old for our age. When money is involved, losses are magnified. This truth sheds light on a topic that has troubled many in finance and finance theory. Behaviorists describe "loss aversion" as a mental fallacy. They argue that people stupidly overreact against the risk of loss. Maybe so, but at Academy, we still often say, "the best way to make money is don't lose money."

We hope this letter deepens your understanding. We want you to stay informed and feel comfortable about our investing discipline. In communicating, we try to "do unto others as we would want done unto us." 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