October 10, 2002

Enclosed are your statements for the third quarter of 2002.

For the quarter, equity investors saw returns of -17.28% for the S&P 500, -17.45% for the Dow Jones Industrial Average (DJIA) and -19.82% for the technology-oriented NASDAQ. These negative returns seem driven by investor anxiety over accounting issues, corporate governance and market valuation. Since the beginning of 1999, equity investors saw annualized returns of -8.86% for the S&P 500, -2.97% for the DJIA and -14.66% for the NASDAQ.

We pay attention to these benchmarks, the S&P 500 in particular. Over longer periods of time, ownership of the S&P 500 will provide a rate of gain in intrinsic business value representative of the economy. This is a reasonable rate. Our goal, and an important reason for our employment, is to provide a higher rate of gain of intrinsic business value for your portfolios. 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 0.97% for the 1 year Treasury Index, 7.83% for the 5 year Treasury Index, and 11.21% for the 10 year Treasury Index. These returns seem driven by the investors seeking safety in bonds. In line with such increased anxiety, 10 year BB- corporate bonds saw returns of -3.14%. The Treasury Inflation Protection Securities (TIPS) we have emphasized continue to be an outstanding choice for fixed income investments.

In reviewing your statement, you will notice some changes. As mentioned in the last letter, 2002 is the first year since 1998 that we have sold stocks, in spite of our preference **to hold the stocks we buy indefinitely**. Yet, after selling four companies in the second quarter, we did it again, selling Microsoft, Newell Rubbermaid, Gillette and Cendant during the third quarter. Further, we have rebalanced some of our smaller positions.

In owning a stock, the most critical factors are not general economic or market conditions; rather, they are the quality of the business and the price of the business. Over time, high quality companies command a high price and low quality companies trade at low prices. These patterns cause investors to ascribe business quality to business price. That is a mistake. Most companies have wide annual volatility of prices while few companies have wide annual volatility of quality. We invest when the prices of high quality companies are lower than appropriate. This happens regularly, but it does not happen every day and so we are loathe to sell our position at a short-term trading profit. We like to hold out for the long-term business-owning profit.

Yet due to the accounting environment changing, we reappraised the impact on the businesses in our portfolios of expensing stock options and reevaluating pension commitments based on more conservative assumptions. These adjustments significantly decreased our valuation of Microsoft and Gillette. When the rest of the market takes an equally hard look at these fundamentals, we may feel fortunate to have made a profit on these companies' stock.

We have also taken a harder look at the debt levels our companies carry. Business schools teach methods of debt analysis that the ordinary layman would never adopt, although for a time we did. On reflection, we prefer the layman's simple approach: look at the number of years of profits to payoff all debt. If more than four years, do not buy. If the debt payoff period of a company we own grows to more than four years, sell at a profit. If it balloons to more than seven years, sell immediately. Three of our businesses were in violation having debt of more than four years, but less than seven: AOL, Cendant and Newell Rubbermaid. In the case of Cendant and Newell Rubbermaid, we had significant profits and realized them. In the case of AOL, we are monitoring the debt level as we presently have an unrealized loss and expectations that the company will be reining in its debt levels soon.

All of these transactions are building towards an unpleasant byproduct: taxes. As stated above, we prefer to hold our stocks indefinitely. Yet, if situations change or prices rise excessively, realizing a gain and paying the tax is far superior to watching the stock plummet and realizing a loss. While we may have spared you the less attractive of those alternatives, you need to begin preparations for the tax impact of these recent sales.

The performance this quarter has been ideal. Your bonds, which are a source of investment cash, rose considerably, while a number of your stocks declined. As we have mentioned before, long-term wealth is created by low prices so that we can increase your ownership in these stocks. Lower prices are only a problem if you have run out of "dry powder." Lower prices are wonderful if portfolios have cash and we have lots of it.

Thus, in your current statement, you will notice a high level of cash. As we've stated before, [**long time clients can skip this paragraph**], we do have to hold some cash in your portfolio. This causes us as much joy as it does you. We realize that you do not pay us to hold cash. However, to act quickly, we must have cash on hand. Warren Buffett once commented that it was no fun having cash burn a hole in his pocket, but it was more fun than having that cash burn a hole in someone else's pocket. We cannot invest it until we see good opportunities.

We did find one opportunity that was mentioned in 2000: educational stocks. We were irreverent enough to ask for prayers lowering the prices of the stocks. We got what we deserved - their prices went through the roof. So we will mention reverently that during the past quarter, we bought DeVry. DeVry Institute is one of four educational stocks that we want to own. For-profit schools have a tremendous opportunity. Non-profit competitors are saddled with objectives other than classroom training. For-profit schools have accreditation that provides a durable competitive advantage. Further, students borrow money from the government and pay for their goods at the beginning of the term. It appears that educational businesses will have slowing enrollment due to the cooling economy and we would welcome any weakness in the prices of these businesses.

We will continue a patient, but 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