January 12, 2005

Enclosed are your statements for the fourth quarter of 2004.

For the quarter, equity investors saw total returns of 9.23% for the S&P 500, 7.59% for the Dow Jones Industrial Average and 14.87% for the technology-oriented NASDAQ.

For the quarter, fixed income investors saw returns of 0.16% for the 1-year Treasury Index, -0.08% for the 5-year Treasury Index, and 0.29% for the 10-year Treasury Index. The riskier 10-year BB- corporate bonds rose by 3.14%. These low U.S. government bond returns were in response to the Fed’s continued current rate raising campaign.

The past quarter provided investment opportunities. For the quarter and the year, the pharmaceutical sector had the worst performance of all sectors. The last time for such poor drug stock performance was in 1993. In retrospect, that was an outstanding opportunity to invest in this sector. We bought then and are buyers again. We have been buying since 2002. At that time, drug stocks became reasonably priced. Since then, they have dropped in price and we have bought more. This does not worry us. In fact, we are pleased when such opportunities arise. Yet, this approach to the market is unusual enough in today’s high portfolio turnover world to warrant some discussion.

Time is on our side for two reasons. First, by studying the past, we can determine which sectors are inherently more desirable. Drugs, insurance, consumer brand staples and a few other sectors generate consistently better returns for shareholders. Second, once we have prepared our analyses, we can wait patiently. These sectors, given enough time, will get to a buy price. Stockbrokers call our investment ideas “dead money,” because there is no apparent catalyst for the next six months. We prefer to call them “big, slow ideas” because they drive our investment returns year after year. Unlike most investment firms, we are fortunate to have a clientele and their advisors who allow us the time to exploit these ideas. Our superior results are in large part due to their patience.

The drug sector has a long history of commercial success. In 1776, Adam Smith wrote about high profits in drug companies. He stated that “apothecaries’ profit is become a bye-word, denoting something uncommonly extravagant.” He defended this profit, writing: “This great apparent profit, however, is frequently no more than the reasonable wages of labour. The skill of an apothecary is a much nicer and more delicate matter than that of any artificer whatever, and the trust which is reposed in him is of much greater importance…His reward, therefore, ought to be suitable to his skill and his trust, and it arises generally from the price at which he sells his drugs.” This long history of profits has allowed some of the drug companies to pay dividends for over one hundred years. Even more striking, in 2002, the profits of the ten drug companies of the S&P 500 were greater than the profits of the other 490 companies combined.

Are there structural reasons for this? We believe so. The drug industry genuinely increases people's well-being. It focuses on three critical areas: helping people feel better, look better and live longer. The good news is that drugs are unlike the products of most industries where saturation sets in and revenues flatten or decline. Revenues on a drug typically accelerate throughout its patent life. The bad news is that unlike branded consumer staples, drugs have something like cliff-like depreciation rates as generic drugs exploit patent expirations almost overnight. The outcome is that the drugs delivered have a huge markup comparable to software, as each drug must fund a return on discovery research (possibly as much as $800 million per successful drug) and fund a replacement of itself in the pipeline.

At this point, we have made 60-70% of the commitment we wish to make to drugs. Even though drug stocks are fairly inexpensive, the overall market is not. The Federal Reserve now appears concerned about asset price inflation, and they have been successful at pricking bubbles. Thus, there are reasonably likely scenarios in which drug stocks could move down even further as part of larger market forces. We want to be prepared to exploit such opportunities.

As said before, our mission is to provide superior performance to the S&P 500 while concentrating on safety of principal. We see, and have seen, these two goals (superior performance and safety) as compatible. This is especially critical, because, "in selecting common stocks, we devote our attention to attractive purchases, not to the possibility of attractive sales." Purchases at unattractive prices create poor results and risk. You might note some rebalancing in your portfolio, as we change some positions in order to increase or be ready to increase other positions. If we own companies whose prices offer much less attractive returns than others, we reallocate accordingly. Taxes at today’s relatively low levels are less of a deterrent to making such changes.

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

Academy Capital Management