July 18, 2016

Enclosed is your statement for the second quarter of 2016.

Clearly, we are not in a "normal" post-recession recovery. That is reasonable given that the most recent recession was caused by a financial market failure rather than a central bank induced slowdown. Recoveries after such failures are slow (20 years plus), due to the challenges of shifting debt from the private sector to the public one. Negative interest rates ("real" or nominal) are a necessary by-product of this shift – as is the accompanying fear of equity markets and the preference for bonds. Severe political and social instability are also characteristic of such a large shift. The U.S. has been making this difficult shift more quickly than others and is benefitting. The next stage of this process typically involves more fiscal programs (such as the public works and enlarged social programs after the Great Depression) and we think they are likely. So, in spite of the high current level, the public debt to GDP ratio is likely to grow.

That said, we do not invest by making broad economic forecasts. Rather, we try to view each investment as a business owner might, with an emphasis on understanding the strength and worth of its business model. But today's low rates have multiple impacts. One is to drive investors towards dividend yields, forcing us to trim some stock positions due to a rise in prices beyond their underlying values rather than due to a pessimistic outlook. The other is to fund disruptive ideas (such as Uber), accelerating the erosion of competitive advantages and causing us to sell or trim some positions affected. The combined result should have been an increase in cash which has not occurred because periodic mini-panics have created investment opportunities. We expect more of these.

In the second quarter, we customarily discuss the earnings growth of the companies that formed the bulk of our prior year's investments. There is an important distinction here. We look at the earnings growth *per share*. Many companies, including some in our portfolio, have been more concerned with increasing earnings and size than per share value.

This is a common issue. With the above-mentioned debt shift becoming a global constraint on growth, weakened aggregate demand has meant that the growth of many companies has stagnated. One way to counter this stagnation is to turn to mergers and acquisitions. The combination of high stock prices (to be used as currency) and low interest rates creates a compelling "deal" environment. The result is larger companies with "growth", but after all is accounted for, it is difficult to see much per share value added.

Another strategy for company "growth" has been the repurchase of shares as a way of driving up earning per share (EPS). We have discussed this strategy favorably in the past as an alternative to purchasing new businesses outside the company's competence. We applauded this approach when balance sheets were generally cash rich and, after 2009, stock prices were low. However, this strategy has become a seductive way to mask the impact of stock options in the midst of rising prices as well as to generate higher EPS. The favorable impact on executive compensation is also tempting companies to use cash for buybacks that, after all is accounted for, not only does not add much per share value but also impairs their financial strength.

We prefer companies that grow organically and gain market share by investing in their business. In the long run, such investment creates superior shareholder value. To do so, however, takes long-term leadership and financial strength because market share growth is not only slow, but expensive. Along the way it may even narrow margins, depress earnings and drop the stock price. Not surprisingly this is the road less travelled, but it has long been the source of our best investment opportunities.

As we have written previously, we look for long-term (10 years or more) aggregate EPS growth of 6-8% per year in the companies we hold in our portfolios. This growth is what ultimately drives market value growth. During 2015, we held the following companies for the entire year. We have listed the changes in their year over year EPS changes in percentage terms after the company names:

Company	**% Change in EPS***
Abbott Labs	-6%
AFLAC	0%
BP, PLC	-131%
Citigroup	145%
Coca-Cola	-2%
Comcast	11%
Expeditors	25%
Google (Alphabet)	10%
Heineken	17%
IBM	-13%
Intel	1%
Johnson and Johnson	-4%
Microsoft	1%
Nat'l-Oilwell Varco	-55%
Nestle Sa	3%
Oracle	-3%
Pepsi	9%
Philip Morris	-7%
Procter & Gamble	-5%
Wal-Mart	-10%
Western Union	2%
Zoetis	13%

*For EPS, we have used Value Line's most recent numbers using the closest fiscal years. These EPS represent Value Line's best attempt at a description of after – tax operating earnings per share. (Nestle's EPS excludes sale gain of Galderma.)

The average increase in the EPS of our stock holdings was a miniscule 0.07% last year. Even removing the extremes of BP, Citigroup and National Oilwell Varco, the increase was only slightly above 2%. Just as in other years, the average reflects some industry-specific issues, but 2015's EPS average increase was below our target, even though company execution was sound. This continued slow earnings growth is an indicator of the current challenges discussed above.

We highlight earnings regularly because it puts the focus on the underlying business rather than the stock price. As stated in the 1996 Berkshire Hathaway annual report: "If you aren't willing to own a stock for ten years, don't even think about owning it for ten minutes." The slow average EPS growth directs our attention to underlying business characteristics. We believe that the current environment will continue to be slower than expectations, but price declines are allowing us to find good investing opportunities nonetheless.

We hope this letter helps you understand our process. 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 Margie Shelton at our office. In addition, our website (at www.academycapitalmgmt.com) has our investment reports on the individual holdings in your portfolio.

Government regulations also require us to send the enclosed copy of Academy's Privacy Notice and to make available a copy of our updated Form ADV - Part II (our regulatory filing with the SEC). If you would like one, please contact Robert Stovall at our office.

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

Academy Capital Management