ACADEMY
CAPITAL MANAGEMENT

July 26, 2019

Enclosed is your statement for the second quarter of 2019.

We use the second quarter's letter to highlight our focus on earnings. We look for long-term aggregate EPS growth of 6-8% per year in the companies that we hold in our portfolios. This growth is what ultimately drives market value growth. This correlation between earnings growth and market value growth was particularly close for the companies we owned over the past year. For these companies, the prior five-year EPS growth and the prior five-year price return (excluding dividends) were an identical cumulative 32% or 5.7% per year. What was striking though was the differences in performance of companies falling within the three categories outlined below.

As a value investing firm, we have gone through an evolution. In our earliest period, we sought "deep value" opportunities in which the "book" value or "break-up" value was often greater than the market value. In these cases, our investing mantra was "buy the assets, sell the earnings." Over time, it became clear that these "deep value" opportunities were often "cyclicals" – a designation indicating their variable earnings stream. For the most part, investing in these "cyclicals" has been rewarding but tends to result in a shorter-term (for us) portfolio turnover of about three years. Seeking a longer-term horizon to reduce turnover (and defer taxes) and find more durable business franchises, we reduced exposure to "cyclicals." We currently have roughly 15% of our portfolios in this category, but wish we had 0%! Prior five-year EPS declines averaged 37% and prior five-year price declines averaged 25%. We believe our investments in this category will still do well, but we have eliminated coverage of new "cyclicals," so they will "lead us not into temptation."

*It is important to reiterate that because we manage individual portfolios but write a general letter, your portfolio may vary from the stocks assumed in our discussions.

By focusing on more durable business franchises, we built the cores of our portfolios around what we termed "equity bonds." These are companies whose earnings were so predictable as to appear bond-like. These predictable earnings were mostly driven by brand characteristics, like Coca-Cola, Johnson and Johnson, Pepsi and Procter and Gamble. Further, these companies could be often held for a decade or longer as price movements tended to move steadily with earnings growth. However, two factors started to reduce their attractiveness: prices outgained as they became known as "expensive defensives" at the same time as multiple factors colluded to stall market share gains. We currently own roughly 60% in the category – a comfortable percentage. However, the headwinds we have identified have caused prior five-year EPS increases to be 18% while prior five-year price increases are 19%. Unless interest rates rise considerably, our future investment in this area will be more limited as the value received for current pricing is unattractive in this category.

500 NORTH VALLEY MILLS DRIVE, SUITE 200
WACO, TEXAS 76710
254-751-0555 P 254-751-0611 F

The final category of stocks is a group we term “compounders.” We use this designation to identify multiple factors likely to drive earnings growth. We can use a simple example here with Mastercard. Mastercard has the likely ability to issue more cards as one factor for growth and the likely ability to encourage increased card spending on each card as another factor for growth. Years ago, we purchased American Express as a “compounder” but because American Express retains credit risk (unlike Mastercard), significant recessions can make it a “cyclical.” These “compounders” are attractive to us because they have multiple tailwinds driving EPS growth. Unfortunately, these companies have been attractive to others, too, and their stock price has been high. Paying “nosebleed” P/E ratios has been hard, but nonetheless we have done so and we’re glad we did. We currently have roughly 25% of our portfolios invested in this category. Over the past five years, EPS increases have averaged 125% while price increases have averaged 111%. It’s important to note that there is no free lunch, and the downward volatility of these holdings in a recession is much greater than those of the other categories, particularly the “equity bonds”.

We hope that this brief discussion illustrates why we have been selectively trimming in our “cyclicals” and “equity bonds,” while building positions in our “compounders.” 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 Joyce Bell at our office. In addition, our website (at www.academycapitalmgmt.com) has our investment reports on the individual holdings in your portfolio. If you would like a copy of Academy’s updated Form ADV Part2A Disclosure Brochure, please contact Kari Siler at our office.

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

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WACO, TEXAS 76710
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