ACADEMY
CAPITAL MANAGEMENT

October 11, 2014

In this letter, we follow our occasional practice (adopted at the request of clients hoping for a little variety) of commenting on our investment process, rather than focusing on specific investments, but an abbreviated investment report will follow the broad-brush comments.

During the past quarter, we have increasingly noted two sets of nervous clients: those with money in the stock market and those without money in the stock market. Historically one or the other group has been nervous, but generally not both. Is this really one of those periods that we can claim, “this time it’s different”? We think so.

The most remarkable aspect of today’s environment is the continuing absence of earnings on short term savings. Zero percent interest rates have certainly been a remedy for the short-term liquidity and solvency environment made manifest in 2008, but they have facilitated a huge transfer of wealth to borrowers and investors from savers. For every person, excited about low mortgage rates, there are a couple of retirees wondering how to fund their retirement.

Like other investors, we have been pleased with restoration of the U.S. economy to fuller capacity with lower unemployment levels, new business creation and the resumption of building projects. However, without the fundamental anchor of short-term interest rates pulling some amount of capital to the safe ground of money market funds, CDs and US Treasury bills, the investing environment loses its bearing and valuations become distorted.

These distortions are not static. Rather, the longer the environment of zero percent interest rates remains central bank policy, the more pervasive the impact. Bond markets were the first place to show these distortions. Initially, bond investors were elated as their holdings rose in value. But that joy began vanishing as their bonds were called or matured. By 2012, bond prices had risen so high that we were writing about bonds moving from risk-free returns to return-free risks.

While some investors simply reinvested their funds at lower and lower yields, others moved on to more speculative grade bonds, nervously reaching for yield. News stories about a “bond bubble” and warnings from the Federal Reserve about another potential round of defaults and losses failed to stem the influx of money.

Given zero percent short-term rates and miniscule long-term rates, it was only a matter of time before these distortions would find their way into the stock market. As a long-time client of the firms aptly summarized in a recent meeting, "we really have no choice but to invest in equities." That sentiment has been echoed by individuals and institutions around the country, driving stocks to record levels.

We have noted the magnitude and frequency of the rise in our investment committee meetings. Our process reviews a broad range of companies across many industries. Throughout the year, we regularly price these companies with respect to their earnings and assets. While the stock market rose a lot, earnings rose a little. In fact, recent studies show that over 80% of the stock market's rise has been attributable to an expanded P/E ratio – that is people simply paying more for a dollar of earnings.

The result is logical since the value of stocks is simply the sum of all future cash flows discounted by a certain rate of interest. The lower the rate, the more valuable all the future cash flows. That puts investors like us in a peculiar position – are we really going to use a discount rate based on these low rates? Answering this question leads us back to our two nervous groups.

The group which is nervous because they have money in the market is intuitively recognizing that much of the rise in the stock market is not because all is well in the financial marketplace. Other than a huge rise in central bank cash, little has changed since 2008. Higher prices in stocks with little increase in earnings has caused us to trim some of our positions. Like the bondholders we discussed, our 2013 joy has vanished into 2014 cash and taxes.

On the other hand, the group which is nervous because they do not have money in the market is intuitively recognizing the missed opportunity of a P/E expansion that can't logically be repeated. While we sympathize with the misery of a cash heavy position, the current market represents a great deal more danger at these increased P/E's.

Robert Shiller, of the famed Case-Shiller real estate index and predictor of the 2008 crisis, has established a value measure of the stock market called the CAPE ratio which stands for "Cyclically-Adjusted Price-Earnings". This indicator is currently at 25 – a level exceeded only in three previous periods: 1929, 1999, and 2007. Each period was followed by major market drops.

Although his measure and other valuation measures concern us, we believe that the current distortion lies not in group euphoria –as in those other periods, but in the central bank suppression of interest rates. Despite the difference in cause, we have a similar challenge to 1999 and 2007 – find stocks whose valuation is not so lofty. This means that we are increasingly forced to look for return in businesses which are experiencing difficulties, just at bond investors since 2012 have been forced to search for yield in less attractive areas. Recognizing that, we are extra cautious, keeping in mind Warren Buffett's admonition, "the less prudence with which others conduct their affairs, the greater prudence with which we should conduct our own affairs."

We hope that this discussion has been relevant. In the spirit of our partnership, we want to provide insight into our process as if you are present at our investment committee. Briefly returning to our investment report, we present the results of the third quarter of 2014.

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.

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

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