ACADEMY
CAPITAL MANAGEMENT

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During the past quarter, there was an investor shift as emphasis moved from lower risk investments to higher risk ones. Such shifts are part of the typical "noise" of markets that hold little useful information. But investors are consistently increasing holdings in stocks with steady earnings and high dividend payouts. These stocks, which we have long called "equity bonds," form a core of our portfolios. As their prices outpace their earnings, we have been selling some of these "equity bond" holdings. The result has been increased cash in your portfolios. As we have noted at times in the past, high cash levels test our patience as we wait for attractive investment opportunities.

In our third quarter letter, we have a tradition of addressing broader issues that go beyond specific portfolio holdings. In this vitriolic election season, we think that it is might be useful to discuss those issues that we consider relevant.

There has been much discussion about the horrors of slow growth. We don't share this opinion. It is true that politicians and economists were excessively optimistic in their post-Great Recession growth estimates but "overselling" policy benefits were probably necessary to gain support for their policies. Our view is that slow growth with subdued inflation has been a favorable environment for a sustained recovery, but we believe that the time has arrived for a shift in policy tools.

To get a sense of where we see ourselves, it's appropriate to review where we've been. In 2008, our financial system experienced a sudden financial contraction resulting in a "liquidity trap." In a liquidity trap, the private sector (made up of individuals and businesses) decreases spending in order to save funds and reduce debt. The result is a significant drop in aggregate demand. The "liquidity trap" of 1929 is what led to the Great Depression in the U.S. and is the condition that has gripped Japan since 1990.

To escape a liquidity trap and prevent a depression requires effective offsetting actions by the government. The government has two kinds of tools – one is monetary (such as changing interest rates) and the other is fiscal (such as major government spending). During the early stages of a liquidity trap, tax revenues drop as private sector income falls. The result is an increase in government deficits. These increased deficits defeat early attempts to use fiscal spending as an effective offset. Instead, monetary approaches (aided by central bank independence and opacity) become the critical early offsets – and these have been effectively deployed.

While these monetary offsets have created a favorable environment for the repair of private balance sheets and the reregulation of finance, these tools can only carry us so far.

Private sector debt continues to drop due to decreased confidence and increased regulation. To offset these declines in private debt, the next stage of a healthy economic recovery requires government leadership in the form of fiscal spending.

Fortunately, both political parties are highlighting increased fiscal spending. Fiscal spending is important so that the private sector increases confidence so as invest in the future, create jobs and increase aggregate demand. We are optimistic that this "golden goose" of U.S. private-public partnership will continue to lay eggs. The division of those eggs will drive incendiary debate, as to the wisdom of strategic tax breaks versus wealth redistribution, but for us, that debate is peripheral as long as the fiscal policy levers are pulled. In this, we are "demopublicans" as it appears that all parties are now willing to move forward with fiscal stimulus.

We do believe that while monetary policy has been constructive, it should not be prolonged indefinitely. The long term intended consequences of monetary policy distort financial structures. First, savings (such as money markets or CDs) has been discouraged with negative rates. This has disproportionately punished the incomes of retired savers. Second, pensions and insurance companies who invest in bonds to fund long term annual costs are increasingly forced to choose between loss of income and loss of principal. Third, stock investors have experienced a lengthy period of unprecedented government support. This reduced stock market risk has important unintended consequences.

Normally the central bank follows a counter-balancing approach to the stock market. When times are good and investors are happy, central banks tighten money. They do this because investors in a good mood prefer funding good ideas rather than good cash flows. The result is malinvestment with a subsequent lowering of profit margins and returns.

For example, during the Tech Bubble of 1999, the central bank tightened money against investor euphoria. But even though euphoria is now absent, prolonged monetary support is generating a 1999-like environment where good ideas are funded with little regard for cash flows. Increasingly stocks are not the present value of future cash flows, but are funding sources for the disruption of industries. As Jeff Bezos, the CEO of Amazon, says "your profit margin is our opportunity." This presents a challenge for investors like us who invest based on profits and profit margins.

Related to this dynamic are calls for increased investment "performance." Investors become frustrated by managers who don't seem to "get it" and are reluctant to buy stock in these disruptive companies. As investors move funds towards these companies, price increases become self-reinforcing. Investment risks increase as prices become untethered from value.

Despite these challenges, in the U.S. we have experienced a successful emergence from a liquidity trap. We are looking for effective fiscal spending to move us beyond the intended and unintended consequences of long term monetary support. By igniting inflation and raising interest rates, the US will be in a better position to provide global stability as the inevitable issues arise surrounding the fragility of the European Union and political stability within China. We continue our search for companies with competitive advantages at reasonable prices.

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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