ACADEMY
CAPITAL MANAGEMENT

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During the past quarter, there was a continued movement towards pricing extremes, causing one investor to comment "whatever is safe is not cheap and whatever is cheap is not safe." We would go so far as to replace the word "cheap" with "reasonable" in this sentence. Current prices do not hold a "margin of safety" for purchasing. As a result, there has been a deliberate increase of cash in your portfolios. As we have noted at times in the past, high cash levels test our patience (and sometimes yours) 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 last year's letter, we discussed the issues surrounding the "liquidity trap" of 2008, the actions taken by the US Government and the monetary and fiscal levers used. This year's letter will focus on the "unintended consequences" of the government's actions, how they affect your portfolio and the elevated risks they introduce.

The Great Recession of 2008-2009 was rooted in a "liquidity" issue as opposed to a "solvency" issue. The difference between the two is one of time. Liquidity issues are short-term in nature, like storms while solvency issues are long-term, like climate change. In 2008 at a conference at the London School of Economics, Queen Elizabeth asked the question all were thinking: "Why did no one see it coming?" The answer is that liquidity events are like storms, inherently unpredictable, but certain conditions make them more likely to occur and we believe those conditions still persist.

When we conceived our investment discipline at Academy, we sought to answer the questions, "why should we exist?" and "what do we do for the economy?" (With discussions like these, you can see why we chose the name Academy.) We determined that we are essentially a "liquidity provider." Different segments of the market periodically contract and there is need for a long-term investor to step in and provide "liquidity." Much as a pawn shop helps individuals with liquidity needs, so do your funds provide market liquidity during difficult environments. We have often stated that crises are crucial for good returns – because it's really what we get paid for.

Given this fundamental importance, what is liquidity? One little quip gets to the heart of it. Mark Twain once described bankers as people who will lend you an umbrella on a sunny day and promptly take it back when it starts to rain. Liquidity is a short-term lending process. The conditions in which the loan occurs continuously change. Further, if the conditions become hazardous to the loan, despite the loan's increased importance, the arrangement will end rapidly. Using Twain's analogy, this arrangement works fairly well as long as there are more sunny days than rainy days and weather patterns are diverse. However, the arrangement unravels if it rains everywhere at the same time, causing lenders to retrieve and store their

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umbrellas while the consumers stay home out of the rain. No pun intended here, but that is the crux of a "liquidity crisis."

Recently, one of our clients commented, "there's no way we could have another crisis like 2008." We disagree. While we don't make predictions, we continue to see conditions right for significant risks in the same spot – liquidity. Why? First of all, debt continues to be a massive number globally relative to the size of the global economy. Second, global synchronization continues to increase as monetary policies align, "animal spirits" revive and regulations decrease. Third, requirements for the increase of permanent capital have decreased capital productivity which perversely requires increased liquidity to maintain growth.

The issue of decreased aggregate demand has not been solved, but merely kicked further down the road. Decreased rates have created a bull market in everything – building cranes are becoming the national bird. Stocks are high, bonds are high, real estate is high and even cryptocurrencies are booming. Lowered rates have been turbocharged by new techniques such as quantitative easing. These techniques have been effective, but not as much as anticipated. Expectations were that an increase in demand would create inflation and return interest rates to "normal." This has not occurred. Given this anomaly, we believe there are liquidity risks and that *any* tightening could be damaging.

A related risk and leader in the "bigger they are, they harder they fall" category is the historically high price levels of the stock market. It is above the 95% percentile in history. We could discuss more eye-popping metrics, but it is safe to say that much needs to go well at these prices and little needs to go badly for stock market returns to be positive over the next 5 – 10 years. However, one might ask, with interest rates at miniscule levels, doesn't the stock market offer better returns? The answer is it's an "IAD" which means It All Depends.

We have often remarked that capitalism competes to zero profits. So how does it keep going? Scarcity of capital drives a demand for profit margins and good returns. The current environment of ample liquidity, while driving growth and sustaining debt structures has also stoked investor confidence (as indicated by exceptionally low stock market volatility) resulting in an exhilarating array of new products and services that cause many of us to scratch our heads and ask, "how can they afford to do that?" Cheap capital leads to increased competition and ultimately decreased profits. Competition is bad for business!

So, in spite of the current state of market happiness, we see increasing risks. We continue to look for effective fiscal spending that might move us beyond the intended and unintended consequences of long term monetary support. That may occur. Absent that, we anticipate that the combination of periodic liquidity crises and capital destruction will provide opportunities to purchase 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.
As always, we appreciate the stewardship responsibilities you entrust to us and your patience with our investment process.

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