# ACADEMY
## CAPITAL MANAGEMENT

October 23, 2018

During the past quarter, there has been an increase in volatility. Regular readers of our letters know that we view volatility as an investor's friend. The greater the volatility, the greater the likelihood that cash can be exchanged for much higher returns. We have been building our cash levels to take advantage of investment opportunities presented by these price swings.

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 "unintended consequences" of the government's monetary support. In this year's letter, we discuss the impact of "mood," the challenges presented by Fed tightening and the potential impact on portfolios at Academy.

In December of 1996, Alan Greenspan, the then-Federal Reserve chairman, used the phrase "irrational exuberance" to explain "unduly escalated asset values." The phrase became memorable as it seemed to not only explain but predict the huge rise in stock market valuations for the next three years. Also striking was that someone trained in rational philosophy and classical economics would attribute everything to a non-quantifiable "mood." But he was in good company.

John Maynard Keynes was a famous economist noted for accurately forecasting events, such as World War II. Further, his insights into the importance of aggregate demand shaped government policy after the Great Depression. In one of his books, Keynes uses the term "animal spirits" to describe the entrepreneur making a capital allocation decision. Essentially, an entrepreneur of "high spirits" was likely to make an investment even if the numbers did not justify it, while "low spirits" could retard an entrepreneur's investment even if the numbers made it compelling. Again, it was remarkable to see an economist rooted in mathematical analyses to explain the economy by "mood."

Capital allocation is risky. As we have repeatedly mentioned, "capitalism competes to zero profits." In this process, capital is placed at risk of permanent loss. Keynes' analysis of the entrepreneur is relevant to the stock market. Periods of "high spirits" are likely to fund investments even if the numbers do not justify it. Such periods are risky as "unduly escalated asset values" are accompanied by complacency in building sound businesses. When "high spirits" leave, the risk is not just moving from high to moderate asset values, but moving all the way to depressed values accompanied by business failures.

We find ourselves seeing such "exuberance" when searching for non-mathematical explanations for the current environment. A recent Wall Street Journal article cited "about

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83% of U.S.-listed initial public offerings in 2018's first three quarters involve companies that lost money in the 12 months leading up to their debut, according to data compiled by University of Florida finance professor Jay Ritter." Sound familiar? "The prior high-water mark for money-losing companies going public was 2000, when 81% of stock-market debutantes were unprofitable, according to Mr. Ritter's data."

In our view, the "mood" has shifted since the election of President Trump. We viewed the "mood" under President Obama as "well-mannered" and "coordinated" as opposed to the current mood of "emotive" and "individualistic." Monetary policy under Obama was stimulative, but resulted in slow growth. Since the election of Trump, monetary policy has become restrictive, but has resulted in strong growth. This is contrary to reasonable expectations. Debates persist as to whether this change in growth was just a matter of wet logs finally catching fire or a shift in "mood" due to the election of an outspoken and controversial candidate. We are inclined towards the explanation by "mood."

This puts the Fed in a precarious position. At best, the process of withdrawing monetary support for the economy was challenging as it meant we might move from anemic growth to none. However, if "mood" is the underlying explanation, then the current process of monetary tightening could easily trigger a destructive move from "high spirits" to "low spirits." Given the heightened risks associated with "mood," our concern continues to be that the Fed should not act preemptively, but much more slowly than in the past.

In light of continued Fed tightening, we are taking two approaches to reducing risk in your portfolio. The first, as mentioned above, is to hold a greater level of cash than we prefer. The second is that we continue to shift towards "compounders" rather than "equity bonds" in our company research. "Compounders" are more expensive, but have the benefit of multiple drivers for growth, while "equity bonds" are more mathematically precise but have "unduly escalated" prices due to their bond-like nature. We anticipate that the combination of potential liquidity crises and capital destruction will provide opportunities to purchase "compounders" at reasonable prices.

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

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