ACADEMY
CAPITAL MANAGEMENT

January 20, 2017

Enclosed is your statement for the fourth quarter of 2016.

The fourth quarter was truly extraordinary, illustrating a collective inability to forecast the future despite increased volumes of data. After Donald Trump's surprise win, equity markets fell and then powerfully rebounded with the S&P 500 up 3.82%, the Dow up 8.67% and the tech heavy NASD up 1.69% for the quarter. Within the fixed income area, interest rates rose across the entire yield curve, which caused high quality bond prices to drop sharply. It also caused yields on lower quality bonds to disappoint, despite the offsetting effects of the market's increased appetite for risk.

Past observers of the above table will notice that 2016 was the fourth consecutive year in which the five-year average return of the S&P 500 was higher than ours. Initially, we did not include benchmark comparisons like this table in our quarterly letters out of a concern that presenting short term results might distract us and our clients from our focus on long term results. Ultimately, however, we decided that presenting them should over time highlight useful patterns and encourage the "long-termism" we desire. This letter is about one important pattern that emerges from the tables.

The basic challenge of stock market investing is recognizing and acting on the difference between the price of stocks and the value of the businesses that stocks represent. These differences typically occur because of stock market cycles, industry conditions and company specifics. Each is important and we have in other letters discussed the last two and their uses in determining value, but it is the first one - stock market cycles - that has the most pervasive impact on the periodic *spread* between price and value. While there is no precise definition of a stock market cycle, we view it as comprising at least two periods: a "bear" market, which is a period beginning with a "top" and ending with a "bottom" that is at least 15-20% lower than the top, and a bull market, which is just the reverse. Notably, these periods are only definable after the fact.

Basically, bull markets are driven by a collective psychology, sometimes amounting to a crowd mood disorder, that regularly (though alas not predictably) causes market prices to significantly deviate from the values calculated by evidence-based analysis. The more depressive the bear market, the easier it is to find value. Conversely, the more manic the bull market, the harder it is to find such value. Presentations of our comparative results are designed to aid the navigation of these market cycles as prices push us out of bull markets and into bear markets. They also enable us to judge our success in achieving the long-term results we seek by presenting data for a full market cycle.

From the table above, it is evident that investors endured a nearly three-year bear market from the first quarter of 2000 through the fourth quarter of 2002. Then a bull market ensued which ended five years later in the fourth quarter of 2007. This full market cycle shows a pattern: in the bear market, our carefully priced investments had superior results and, in the bull market, our disinclination to chase investments increasingly priced above value gave us inferior results *every single year* in 2003, 2004, 2005, 2006, and 2007.

We are now in the midst of another full stock market cycle, and, so far, the table reveals a similar pattern. From the fourth quarter of 2007 through the first quarter of 2009, we experienced a bear market in which our investments delivered superior results. Since then, we have been in a bull market in which our investments have delivered inferior results in every year from 2010 through 2016 (except for 2011 when a dramatic intra-year bear market allowed us to achieve superior results).

The table also reflects some further facts. First, bull markets *last longer* than bear markets. On average since the 1930s, bull markets have lasted three and a half years and bear markets a year and a half. (The historical five-year average cycle of five years is why we chose five years as a comparative measure in our chart, though the current cycle is already over nine years long.) Second, as noted above, our results tend to be inferior in bull markets and superior in bear markets. Third, the combination of these two factors means that we can expect to experience inferior results *more frequently*. Fourth, and most importantly, over a full stock market cycle we have nevertheless experienced superior results due to finding value in bear markets and avoiding excess prices in bull markets and can hope to do so through the current cycle.

The length of the current bull market is extraordinary. Even more unusual is the lack of investor enthusiasm. This bull market has not been marked by baristas proffering stock tips, but by a shrugging of shoulders with the refrain “what choice do I have?” While that means that there is little risk of a loss of enthusiasm, it does mean that animal spirits could easily be depressed. As prices rise, risks increase. The “Trump Bump” may set up disappointment.

In line with this, we are finding an increasingly narrow investing opportunity set, especially in U.S.-based companies. For new clients, this means that we are investing your low-yielding cash more slowly than usual. For clients with more fully invested portfolios, we are in a process of raising cash positions as prices hit our full valuation levels. If nothing else is clear from this letter, it should be that our investment discipline relies on bear markets which will always show up. They provide wonderful investment opportunities to build long term wealth. We are heeding a sign on the desk of one of our favorite real estate investors that reads, “Real estate is cyclical: Are we prepared?”

Our standing fourth quarter tradition has been to discuss stocks we have sold in the prior year as a means of explaining our investment principles. We will add this discussion to the next quarter’s as the present letter is longer than usual. 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

Government regulations also require us to send the enclosed copy of Academy's Privacy Notice and to make available to you a copy of our updated Form ADV - Part II (our regulatory filing with the SEC). If you would like one, please contact Robert Stovall at our office.

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

Academy Capital Management