April 11, 2006

Enclosed are your statements for the first quarter of 2006.

For the quarter, equity investors saw total returns of 4.21% for the S&P 500, 4.24% for the Dow Jones Industrial Average and 6.38% for the technology-oriented NASDAQ.
For the quarter, fixed income investors saw returns of 0.76% for the 1-year Treasury Index, -1.20% for the 5-year Treasury Index, and -2.80% for the 10-year Treasury Index. In contrast, the riskier 10-year BB- corporate bonds had positive returns of 2.03%. The 1-year Treasury Index return clearly reflects the Fed's continued raising of short term rates. Cash was "trash" two years ago, but is becoming "king."

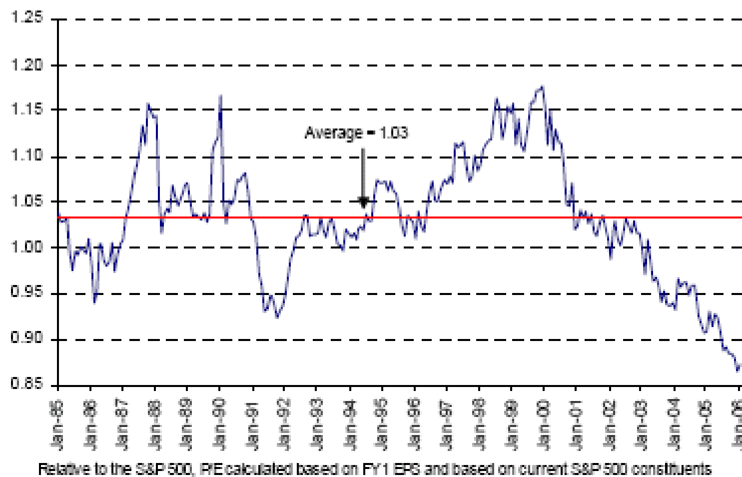
The negative returns for the 5-year and 10-year Treasury Indices were widely anticipated because the higher returns on cash draw funds out of bonds and into cash. These negative returns indicate that longer term interest rates were increasing, providing the desired effect of slowing the housing market and thus, the economy. But these higher interest rates in the low risk U.S. Treasury bonds were accompanied by a surprise: lower rates in high risk bonds.

Typically, the increased attractiveness of cash draws funds out of both the low risk (U.S. Treasury) and the high risk bonds (as measured by BB-). Further, high risk bond values are typically affected by the anticipated credit problems of a slowing economy. So we believe that last quarter's positive returns in the high risk 10-year BB- bond market reflect an ebullient disregard for the mounting economic risks introduced by the Fed's rate-raising campaign.

We are seeing the same disregard for risk in the stock market. The Fed has been raising rates for two years now. As explained above, the markets at this point become risk averse. But, it's been different this time: *assets with higher amounts of risk continue to be the most popular*. A lack of speculation in commodities and their derivatives such as energy stocks has hurt our results in the short run, but we see that as merely symptomatic of a deeper issue. Our risk-aware approach is increasingly out of step with a risk-blind market.

The following graph illustrates the pattern we are seeing. Tobias M. Levkovich from Citigroup compiled this to compare the valuation of the top 25 companies in the S&P 500 to the other 475. Over the last twenty years, the largest 25 companies maintained a premium valuation on average, the amount of which varied in ways that, until 2003, could largely be explained by actions of the Fed. When the Fed was "loose," encouraging risk-taking, the premium valuation of the top 25 disappeared while the premium valuation grew when the Fed was "tight," discouraging risk-taking. So as the Fed loosened money in 2000-2003, the large company premium, as expected, went down. The unexpected reaction began as the Fed raised rates in 2003-present, when instead of increasing as in the past the premium went down even further, *with investors taking more risk with each rate increase*! (Having only the knowledge of this graph, an observer might logically believe that the Fed had now dropped rates to zero in a strong encouragement of risk-taking.)

Figure 7. Relative P/E of the Largest 25 S&P 500 Companies



Top tickers: GE, XOM, MSFT, WMT, BAC, JNJ, AIG, PFE, MO, INTC, JPM, PG, CVX, IBM, CSCO, WFC, PEP, AMGN, KO, HD, COP, WB, VZ, UPS
Source: FactSet and Citigroup Investment Research U.S. Equity Strategy

The companies whose premiums have continued to decline in this unprecedented way include the outstanding ones that, as we have shared before with our clients, we have never been able to justify purchasing because they have been perennially expensive. We now own seven of the 25 included in the Levkovich graph (WMT, JNJ, AIG, PFE, INTC, KO, and HD). Only a small additional change in valuations would create an opportunity for us to buy, at prices consistent with our valuation discipline, six more, putting us within close range of owning over 50% of the most dominant companies in the market.

Our strategy is to continue to purchase such companies and increase ownership where prices decline further. While we did not anticipate such a dramatic decline in the appeal of great businesses, our discipline allows us to take advantage of such declines, but it does require patience. Our results have lagged the market for the last five quarters and will continue to do so until a sense of risk returns and the trend depicted above alters. The Fed will continue to tighten money, raising rates. At some point, investors will look for safety. Inevitably, such patterns overshoot and that's where another set of challenges lie. But that's the future. For now, our job is clear: take advantage of today's disdain for safety and high quality.

In this quarter, we again had a high level of new clients. For those who are new, we welcome you to Academy and want you to stay informed. Past quarterly letters are sometimes useful for a deeper understanding of our discipline. If you wish to receive them, please contact your financial advisor or Sue Compton at our office and they will be forwarded to you. 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.

Academy Capital Management