April 18, 2013

Enclosed is your statement for the first quarter of 2013.

During the quarter, rising asset prices were mostly driven by the prospect of higher returns. Pondering the continuation of extraordinarily low interest rates, investors have been abandoning the risk aversion strategies of 2009 and bid up the prices of other assets. We do not view low interest rates as a bad thing; the global consequences of the popping of the U.S. real estate bubble still linger. But interest rates do serve as valuable pricing information, and when distorted long enough, investors can lose their investment bearings. We think it prudent to keep in mind the aphorism of a Legg Mason analyst, “more money has been lost reaching for yield than at the point of a gun.”

At Academy, we believe the best investment opportunities exist in difficult periods. The recent rise in prices has constrained our shopping, causing your portfolio to sometimes hold significant cash holdings (money market funds and U.S. Treasuries), which we do not like any more than our clients do. While unemployment issues in southern Europe, intransigence of U.S. Politicians, Chinese economic issues and similar news-hour events should provide us with periodic opportunities for purchases, we are not waiting for those to appear. We continue to explore and invest in some areas that we believe are attractively priced, despite the distortions induced by today’s low rates.

The spring quarter’s letter regularly addresses the businesses of the stocks which were newly purchased over the prior year. Last year’s list was a short one with just two purchases. However, both purchases helped us develop insights that have led to several new purchases in 2013. Before we discuss these, it is important to note that because we manage individual portfolios but write a general letter, not all of these stocks may be in your portfolio.

When we purchase stock in a company, we are looking for three occurrences: first, that the company’s earnings maintain or have resumed healthy growth; second, that the company pays out some of these earnings in the form of dividends and share repurchases; and third, the stock of the company languished in price for an extended period. (It is the last occurrence that gives most of you pause; that’s natural – even at Academy, we occasionally lapse into discussions of stock price rather than business merits.)

We are interested in the purchase of great businesses at reasonable prices, where we have stubbornly defined “great” as a huge competitive advantage created by some form of consumer 'monopoly,' such as a brand. In capitalism’s relentless competition to zero profits, we seek safety in these narrowly defined competitive advantages. In the current market investors have been bidding the prices of those companies far beyond our "margin of safety." However, we have discovered new competitive advantages with which we are comfortable, resulting in the addition of two companies that don't seem very "Academy-like" (at least at first glance).

The companies we purchased were Dell and Schlumberger.

Round Rock, TX-based Dell (DELL) is a global computer system and services company. Dell was founded by Michael Dell, who started selling personal computers out of his dorm room as a freshman at the University of Texas in Austin. Dell bought parts wholesale, assembled them into IBM clones, and sold them by mail order to customers looking for low prices. The scheme was an instant success. In his first year of business, he grossed $6 million and dropped out of school. DELL, in some ways, was a classic Academy purchase: a low stock price relative to its earnings and book value. In addition, DELL has a high margin of safety created by a cash position that represents almost 40% of the price we paid for the stock.

But what most attracted us was a specific business model that could be bought "on the cheap." Following a study of Louis Gerstner's "Who Says Elephants Can't Dance?" we marveled at the ability of consultative selling to create high profits out of disparate product lines and, in particular, certain kinds of high margin software selling to drive profitable hardware sales. "Synergy" is typically only a term of hope, but IBM had accomplished it and DELL has adopted a similar strategy. As mentioned above, this line of reasoning has led to several related investments in 2013. Meanwhile Michael Dell has led a group that is attempting to take the company private. We are not interested in speculating on the likelihood that this will cause a bidding war with other investment groups, only in participating in the company's future. As that is not possible, we have sold our investments at a slight profit.

Schlumberger Ltd. (pronounced Shlum-bur-zhay) (SLB), is the world leader in oilfield services, offering products and services that cover oil and gas from exploration to production. Schlumberger was the creation of two brothers of that name, Conrad and Marcel. Based in France, Conrad became a professor of physics at the École des Mines, while his brother Marcel pursued mechanical engineering and business. Conrad became interested in the electrical resistance generated by different types of rock formation and was soon testing his results on the family's summer estate in Normandy. In 1914 Conrad successfully completed the first commercial application of this technique, locating a body of copper ore for a client in Serbia. Subsequently, they set up a business in Paris to pursue the further evolution of electrical prospecting, as it was called. This led to the business of "wireline logs," a business in which they are still dominant globally. Like IBM, SLB has utilized its consultative advantage in reservoir characterization to position itself profitably in other lines of products and services.

The companies we hold are diverse. Some are huge; some not. Some are global; some not. Some pay dividends; some don't. Some are widely diversified; some not. However, our selection of these companies all has one thing in common – a sustainable competitive advantage. There are a limited number of ways to gain and sustain this advantage. In the past we have discussed some of them (such as "brands") but 2012 offered an opportunity to include this consultative approach. We take pleasure in these strengths that our companies have generated. The sometimes wild downturns of the market are much less stressful when our attention can focus on the competitive strengths of our portfolio companies and whether the downturn allows us to increase our ownership at better prices.

We hope this letter helps you understand our process. We want you to stay informed and feel comfortable about our investing discipline. 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. 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