July 15, 2003

Enclosed are your statements for the second quarter of 2003.

For the quarter, equity investors saw exceptional returns of 15.39% for the S&P 500, 13.12% for the Dow Jones Industrial Average and 21.11% for the technology-oriented NASDAQ. Since the beginning of 1999, equity investors have seen annualized returns of -3.70% for the S&P 500, 1.35% for the Dow and -6.17% for the NASDAQ. For the same period, equity-based investors of Academy have seen annualized returns of 9.21%.

For the quarter, fixed income investors saw returns of 0.42% for the 1-year Treasury Index, 2.38% for the 5-year Treasury Index, and 3.40% for the 10-year Treasury Index. The riskier 10-year BB- corporate bonds were driven up by 7.41%.

The rise in stock and bond markets had flattering effects on our own portfolios, but did little to create excellent new investment opportunities during the past quarter. We found none. It is worth reflecting on why this is happening. As we have said before, unless both high quality and good prices are available, we don't get involved. Right now, high quality exists but good prices don't. Yet some investors are claiming good prices at these levels. Why? Let's look at valuation.

The most popular method for valuation (other than the widely used "52 week high") is discounting future cash flows by some interest rate. Using this method, the investor both estimates future cash flows over a ten or twenty-year period and assigns an interest rate to that period. Except in the case of U.S. Government bonds, estimating future cash flows is difficult. However, because the typical business we study has had steady and predictable cash flows, we have a basis on which to make a forecast. Forecasting interest rates is completely different.

There is a joke about the appropriate question put to people with various I.Q.s. For the person with the lowest I.Q., the question was, "which way do you see interest rates headed?" Interest rates move widely and there never has been an accurate method of forecasting them. We have tried. Others have tried. And the result has always been the same: at some point, the forecast is absolutely wrong. Like the weather, interest rates are much discussed, but little impacted. Nevertheless, because of the widespread use of discounted cash flow method, interest rates are the most powerful driver of valuations.

With this method, as interest rates decline, everything with future cash flows - bond, stocks and real estate - go up in value. So when you read in the newspapers that interest rates are at a fifty year low, you could also read, but generally don't, that valuations of bonds, stocks and real estate are at a fifty year high. We're in another bubble, but of a different type than we just experienced.

Because of our inability to forecast interest rates, we don't rely on this method of valuation. Rather, we look at the rate of return on capital, which we think is unrelated to interest rates, and the rate of increase in earnings. From these, we extrapolate future cash flows and calculate a future value using a cash flow multiple based on the characteristics of each company. We then discount this future value to the present by a 15% factor. We know that this discount factor seems exceptionally high, but it gives us a nice margin of safety and plenty of upside potential.

If interest rates are extremely low (as they are today), our "buy prices" will also seem low. Will interest rates stay so low? Will we buy stocks again? These are the types of questions we asked ourselves in 1999. At that time we did not anticipate that demand for technology stocks had a silver lining: demand for buying great companies withered and their shares prices with it. Today's environment will also have a silver lining.

We have rarely found that relying on a government's support of price levels through interest rates or speeches is reliable. Ultimately, prices arrive at a mathematically sound and sustainable level. With such widespread high prices, you will notice a frustratingly high level of cash. This does not mean, however, that we are idle. Rather, we continue our patient and attentive search for the purchase of excellent companies at prices significantly under their intrinsic value.

As always, we appreciate the stewardship responsibilities you entrust to us.

Academy Capital Management