July 12, 2004

Enclosed are your statements for the second quarter of 2004.

For the quarter, equity investors saw total returns of 1.72% for the S&P 500, 1.24% for the Dow Jones Industrial Average and 2.80% for the technology-oriented NASDAQ. Since the beginning of 1999, equity investors have seen annualized returns of 0.09% for the S&P 500, 4.28% for the Dow and -0.89% for the NASDAQ. For the same period, equity-based investors of Academy have seen annualized returns of 8.92%.

For the quarter, fixed income investors saw returns of -0.32% for the 1-year Treasury Index, -3.50% for the 5-year Treasury Index, and -4.78% for the 10-year Treasury Index. The riskier 10-year BB- corporate bonds were driven down by -1.83%.

Quiet reigns amid bubble pricing in both stocks and bonds. Fifty-year lows in interest rates continue. During the past quarter, inflation fears picked up, causing bond prices to drop. But the Fed's rate increase of 25 basis points in June calmed those fears. The stock market has been so calm as to send terror into the hearts of those at CNBC. People are reverting back to traditional behaviors: weekly, rather than minute by minute updates on the market.

Our mission is to provide superior performance to the S&P 500 while concentrating on safety of principal. We see, and have seen, these two goals (superior performance and safety) as compatible. This is especially critical, because, "in selecting common stocks, we devote our attention to attractive purchases, not to the possibility of attractive sales." Purchases at unattractive prices create poor results and risk. The occupational hazard of money managers was well stated in the 1999 Berkshire Hathaway Annual Meeting, when Warren Buffett remarked, “The stock market is a no-called strike game. You don't have to swing at everything-you can wait for your pitch. The problem when you're a money manager is that your fans keep yelling, “Swing, you bum!”

While such yelling has not been a problem with our fans at Academy, the lack of “swing worthy” pitches continues to be a challenge for us. We prefer to use these letters to review the companies we are purchasing or something we understand, but the lack of recent purchases allows for or forces a broader discussion on something that we know a lot less about: the credit market.

Our uneasiness over the high price of the stock market today is very different than it was in 1999. At that time, hysteria was evident with Starbucks baristas and restaurant waiters (instead of Bernard Baruch's famous shoeshine boys) giving out stock tips. Yet, the stock market capitalization now is almost as high as it was then. How is that possible? Why would “hysteria” prices equate with “rational” prices four years later? Has the environment gotten so much better, safer, more peaceful, more profitable? We don't think so. We believe that the credit markets are the key.

Over the past twenty years as rates have declined, the total credit market has experienced dramatic growth, moving from 150% to 300% of Gross Domestic Product. The credit market simply cannot permanently outgrow the economy. At some point, the credit market will slow expansion to move in step with the economy and that inevitable slowing has major implications.

The Fed facilitated high growth in the credit market after 2000 to reduce the damage created by the bursting of the Great Bubble of 1999. As the Fed lowered rates, a massive movement of mortgage refinancing began, triggering rising housing prices and a wave of new construction. The refinancing allowed consumers to spend the appreciation of their homes and still have lower monthly payments. The resulting boost to consumption minimized the damage of the greatest investment party in history. Also helpful was high federal government debt from tax cuts and military spending.

Rapid credit expansion is tremendous for the stock market. Credit contraction or slowing is not. Our concern is that rapid credit expansion must continue for stock valuations to hold. Yet, maintaining high rates of credit growth seems far-fetched. Saturation limits would seem to exist for cars and houses (although the American consumer does continue to amaze us). Further, tax cuts have reached their limits. This does not mean that a credit implosion or disaster must occur. But the expansion of government debt, corporate debt and individual debt cannot continue at the same rate. When they slow, two things should occur. Rates should continue to stay low and go lower and earnings growth should slow.

In response, we are continuing to swing at the same kinds of pitches that we have used since the deflationary scare in 1998. First, we look for high quality companies who have pricing power, good market opportunities and solid balance sheets. Second, we seek to purchase Treasury Inflation Protection Securities (TIPS) when the rate is attractive. Finally, we will joylessly, but resignedly hold cash rather than swing at low percentage pitches. We remain confident that even if current conditions persist, these categories of stocks and bonds will present ample opportunities. We continue our patient and attentive search for them.

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

Academy Capital Management