July 12, 2006

Enclosed is your statement for the second quarter of 2006.

For the quarter, equity investors saw total returns of -1.44% for the S&P 500, 0.94% for the Dow Jones Industrial Average and -7.01% for the technology-oriented NASDAQ. For the quarter, fixed income investors saw returns of 0.83% for the 1-year Treasury Index, -0.16% for the 5-year Treasury Index, and -1.11% for the 10-year Treasury Index. In line with government bonds, the riskier 10-year BB- corporate bonds had negative returns of -0.38%. As we said last quarter, the 1-year Treasury Index return reflects the Fed's continued raising of short term rates. Cash was "trash" two years ago, but is becoming "king."

As we also mentioned last quarter, 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 Federal Reserve Bank's desired effect of slowing the housing market and ultimately the economy.
The increased attractiveness of cash also drew funds out of the high risk bonds (as measured by BB- index referred to above). High risk bond values are typically affected by the anticipated credit problems of a slowing economy; therefore last quarter's negative returns in the high risk 10-year BB- bond market reflect concerns about the mounting economic risks introduced by the Fed's rate-raising campaign.

We think the stock market is also being affected by these risks, as evidenced by the negative returns in the NASDAQ. The Fed has been raising rates for over two years now and the markets are starting to become risk averse.

In light of the increased awareness of "risk," we want to discuss that term, how we use it and what it means to your portfolio. In its broadest meaning, the Oxford English Dictionary defines risk as "hazard, danger; exposure to mischance or peril." More narrowly, statistics defines "risk" as "deviation from an expected outcome." At Academy, we combine these approaches, thinking of risk as a *hazardous* deviation from an expected outcome. The adjective hazardous is crucial, implying permanent loss.

Generally, we do not view deviations from expected outcomes as hazardous. In life as well as the stock market, deviations from the expected are the norm. Just as people get worked up over events in their lives that seem critical in the short run, but ultimately are irrelevant, so too investors get overly concerned about quarterly earnings "misses." (In fact, the recent decision by a number of companies to cease providing earnings guidance seems a healthy reflection of the future's unknowability.) As readers of our past letters probably know, we do not think the resulting volatility in the price of the stock is hazardous. So, where is the risk?

We see risk as essentially inherent in the business, not in the price of the stock. Quarterly earnings "misses" move the price of stocks, causing some frustration or impatience, but do not really affect long-term investment results. On the other hand, the presence of too much debt, poorly structured business plans or cutthroat industry dynamics are all examples of risks embedded in the business. For quarter after quarter such factors will not affect the price and then quite suddenly, the *hazardous* deviation occurs – bankruptcy or a restructuring (such as a very low priced sale or massive share issuance) that results in permanent investment loss.

For us, controlling risk, the *hazardous* variety, occurs at the level of the business. The higher the quality of the business, the easier it is to control risk. For years we have been challenged to find high quality businesses at reasonable prices. But a funny thing has happened. While the world has been gleefully acquiring energy, commodity and third-world (oops, “emerging”) stocks, very risky by our definition, we have been buying world-class companies at prices that have *never* been cheaper on a comparative basis. As a result, our mature portfolios are approaching the fully invested level.

The present affordability of high quality companies has been thrilling, but comes with a couple of challenges for these mature portfolios. The first challenge is that the lack of portfolio growth for the past eighteen months has been frustrating. However, it’s important to remember that we haven’t “run in place,” but have significantly increased in the percentage invested. The second challenge, again for these mature portfolios, is a little trickier: to make the most of the remaining cash. While we don’t forecast the future, we are faced with an anomaly. Typically, great companies would be cheap only in a cheap market. Today, the great companies are cheap, but the stock market is not. The stock market may fall significantly, possibly making our great companies even cheaper, and present more buying opportunities. Our decision, then, is to use our last arrows sparingly. In bow hunting language, we’re only taking “ten-yard shots.”

For all portfolios, our strategy continues to be the purchase of high quality companies and the increase of ownership when prices decline further. Our discipline allows us to take advantage of such declines, but it does require patience. The Fed may well continue to tighten money, raising rates and causing investors to increasingly seek safety. Inevitably, such patterns overshoot and that’s where another set of challenges lie. But that’s in the future. For now, our job is clear: to take advantage of today’s neglect of high quality companies.

In this quarter, we again had a high level of new clients whom we warmly welcome to Academy. We want you to stay informed and feel comfortable about our investing discipline. To do this, past quarterly letters may be useful. 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