July 8, 2010

Enclosed is your statement for the second quarter of 2010.

For the quarter, equity investors saw total returns of -11.43% for the S&P 500, -9.36% for the Dow Jones Industrial Average and -11.83% for the technology-oriented NASDAQ.
For the quarter, fixed income investors saw total returns of 0.23% for the 1-year Treasury Index, 4.61% for the 5-year Treasury Index, and 8.32% for the 10-year Treasury Index and the 10-year BB- corporate bonds had total returns of 0.86%. Analysts have termed the quarter a "retrenchment," as declines were significant in both equity and corporate fixed income markets. These declines were a result of assets being moved to "safety" as investors bid up the value of U.S. Government bonds. We place quotations around safety, because these sought- after bonds are now yielding *less than 3% per year for the next ten years*.

We want to follow our customary practice, now that the 2009 results are in, of commenting on the earnings growth of the companies that formed the bulk of our investments last year. As we have written previously, we look for long-term (10 years or more) aggregate earnings growth of 6-8% per year in the companies we hold in our portfolios. Earnings growth is what ultimately drives market value growth. During 2009, we held the following sixteen companies for the entire year. We have listed the changes in their year over year earnings per share (EPS) changes in percentage terms after the company names:

Company	**% Change in EPS***
Allstate Insurance	8%
American Express	-34%
Comcast	13%
Hershey Foods	0%
Home Depot	-7%
Intel	-16%
Johnson and Johnson	1%
Legg Mason	-49%
Masco	-57%
McGraw-Hill	-11%
Microsoft	-13%
Moody's	-11%
Sysco	-2%
Time Warner Cable-A	-19%
Unitedhealth Group	10%
Wal-mart	7%

*For EPS, we have used Value Line's most recent numbers. These EPS represent Value Line's best attempt at a description of after-tax operating earnings per share.

After weighting the results for the size of our holdings, the average *decrease* in the EPS of our stock holdings was 9% last year. Just as in other years, the average reflects some industry-specific issues, but 2009's results (like 2008's) were driven primarily by systemic credit issues. The collapse of credit continues to be deflationary, despite vigorous governmental spending initiatives. For years, we have included an analysis of the potential impact of deflation in our investment selection process. This work paid off as our holdings generated profitable operating results during these difficult times through a combination of competitive advantages and strong balance sheets.

We highlight earnings regularly, because it puts the focus on the underlying business rather than the stock price. Earnings are also less volatile than stock prices, but vary widely when studied annually as we do in our letters. Because earnings have declined two years consecutively, we wish to share with you how we think about volatility in earnings. For those not inclined to such a detailed discussion, simply skip the next three paragraphs and remember the motto, "things are never as good or as bad as they seem."

In prior letters, we have stated that price volatility is the norm in the stock market and stressed how important this volatility is for our investment process. Without Mr. (Stock) Market putting his goods on sale, we would not be able to make bargain purchases. Similarly, earnings volatility is the norm of the business world and is important to our investment process.

An astute investor once said, "buy the assets and sell the earnings." This short phrase highlights that businesses have productive capacity from which earnings are generated. This productive capacity is expensive with many "fixed costs" to keep that capacity in place. Every dollar of sales above the fixed costs is highly profitable, making the last dollar of sales the most important. In this way, small changes in sales can lead to large changes in earnings.

Investors, in their quest for simplification, forget this. By focusing only on good earnings and the related ratios, they purchase businesses which are operating closer to full capacity. Even worse, these investors are purchasing businesses at full capacity when these businesses are most pricey. For this reason, we pay careful attention to measures beyond earnings, such as sales, replacement values, historical valuations and business components. Yet, over longer periods of time, earnings growth is the primary driver of market valuations.

So, even though earnings have dropped over the last two years, the drop in earnings overstates the decline in business values. As a result, we continue to find a disconnect between price (what you read about) and value (what such an asset would bring in a private sale between two business-minded investors) which is nearly as severe as in 1999, but in reverse. Back then, the price was wildly higher than the value - particularly in technology, whereas today's price is lower than the value - particularly in the large, multinational corporations which we have recently purchased. These are powerful business franchises with global capabilities which are nearly impossible to replicate. They represent the best of the best.

As stated in the 1994 Berkshire Hathaway annual report: "we have usually made our best purchases when apprehensions about some macro event were at a peak. Fear is the foe of the faddist, but the friend of the fundamentalist."

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 Sue Compton 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