October 14, 2004

Enclosed are your statements for the third quarter of 2004.

For the quarter, equity investors saw total returns of -1.87% for the S&P 500, -2.90% for the Dow Jones Industrial Average and -7.24% for the technology-oriented NASDAQ. Since the beginning of 1999, annualized returns have been -0.24% for the S&P 500, 3.56% for the Dow and -2.13% for the NASDAQ. For the same period, equity-based investors with Academy have had annualized returns of 8.48%.

For the quarter, fixed income investors saw returns of 0.48% for the 1-year Treasury Index, 2.97% for the 5-year Treasury Index, and 4.99% for the 10-year Treasury Index. The riskier 10-year BB- corporate bonds rose by 4.81%.

We did see some increased volatility in the stock market. This is important. Volatility is helpful to us in building our portfolios, as wider ranges of stock market values create greater opportunities for investment. In response to the Federal Reserve's raising rates twice during the quarter to 1.75%, investors seem to be more demanding of companies whose earnings disappoint short term expectations. Such reactivity has been particularly encouraging to us.

On a historical note, volatility is the norm in the stock market. We are indebted to Morgan Stanley analysts for the following: "While many advisors are now indicating a stock market with 8-10% returns over the next decade, in how many years since 1926 did it generate a return of between 8-10%? In this period of 78 years, a "normal" return of 8-10% was only achieved **once** – in 1933!" That statistic indicates the manic depressive nature of the stock market.

As mentioned in earlier letters, we make a distinction between stocks and businesses. We look for good businesses that have "bad stocks" (the ones that go down). Over time, such opportunities are difficult to find, as investors are not unintelligent, just impatient. We are not the only investors who understand that a good business is one that has consistently high returns on capital without the use of debt or stock issuance, so to purchase these businesses is typically very expensive. Still, in today's low cost of capital environment, investors as a whole seem to be more interested in companies achieving high rates of growth, even if that growth comes through using "cheap money," such as low-interest debt or stock issuance. While the broader market follows that idea, the stock prices of some high return on capital companies are dropping to attractive price levels.

The companies we purchased this quarter have dropped precipitously over the past year, but have returns on capital that put them consistently in the top 10% of all companies. Such consistency is important for two reasons. First, returns on capital that has been driven up by the radical actions of new management usually end up as temporary improvements. Second, larger issues, such as our sizeable trade deficit, our growing domestic debt and heightened risks of terrorism pose significant, but difficult to quantify risks for all companies. Consistently high returns on capital are an indication of a business's likely durability in the face of such risks.

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. You might note some rebalancing in your portfolio, as we change some positions in order to increase or be ready to increase other positions. If we own companies whose prices offer much less attractive returns than others, we reallocate accordingly. Taxes at today's relatively low levels offer additional incentive to make such changes.

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

Academy Capital Management