October 10, 2006

Enclosed is your statement for the third quarter of 2006.

For the quarter, equity investors saw total returns of 5.66% for the S&P 500, 5.34% for the Dow Jones Industrial Average and 4.15% for the technology-oriented NASDAQ. For the quarter, fixed income investors saw total returns of 1.50% for the 1-year Treasury Index, 3.35% for the 5-year Treasury Index, and 4.98% for the 10-year Treasury Index. In line with government bonds, the riskier 10-year BB- corporate bonds had total returns of 4.30%. These positive returns reflect a collective sigh of relief over the Fed's decision to leave short-term rates at 5.25% after 17 consecutive increases. In June 2004, those rates were at 1%.

Our portfolios increased in value during the past quarter, with our stocks generally rising higher than market averages. While such price behavior makes our clients happier, long term readers of these letters know that we do not necessarily believe that it makes our clients richer. We have repeatedly argued that lower prices are important as they offer better prospective returns, an inversion of the old saw "the bigger they are, the harder they fall." Some clients have eagerly waited for portfolios to become fully invested so they could begin cheering for their stocks to rise in price. After all, who likes to cheer for their favorite team to get even further behind? Yet, the investing business shares some characteristics with gambling (only the positive ones, of course!). So, if you really believe your team will win and if you are correct, then worse odds are better because they will yield higher payoffs.

But is it true that clients with fully invested portfolios should begin cheering their stocks to greater heights? Not always, we think. Nearly 70% of the companies we own (24 out of 35) are buying back their stock. Further, over 50% of the remaining companies have intentions to do so, but have temporarily suspended those share repurchase operations for a variety of reasons. If the prices of our stocks went down (assuming the earnings are at least stable), the earnings per share of 70% of them would expand as the number of shares shrank. Past readers may recall our contention that long term value is most closely related to the earnings their shares represent. So the shrinkage in the number of shares and the resulting increase in earnings per share is a happy scenario for us. At the extreme, we would be ecstatic if the company were to repurchase all of their other shares at increasingly lower levels and leave us as the sole remaining shareholders.

The favorable pattern that declining prices can have has been illustrated with the results of our strategy with drug stocks. For years, we have been impressed about the characteristics of drug stocks but it was not until April 2002 that we created a process for investing in them. We were uncomfortable with blindly buying a drug index, but we were equally uncomfortable with relying on too few companies. Announcing our strategy in our client letter of the second quarter 2002, we wrote, "In the case of the pharmaceutical business, we like the industry even more than we like the individual companies, whose fortunes depend on unknowable factors like their ability to get drugs

approved…With attractive industry characteristics and the difficulty of company comparison, we believe the strategy of buying the industry through a "basket" of companies is best.” Some could argue that our timing was miserable (since we don’t think in terms of timing, we would argue it’s actually non-existent). Looking only at market prices, the drug industry and those individual stocks have done poorly as investments, or so that argument would go. How did the results of our strategy compare?

We included twelve drug stocks in our earliest studies, but we had to exclude four of them because of accounting complexities despite their industry stature. The remaining eight that we have been purchasing (and selling) since April 2002 are: Abbott Laboratories (ABT), Bristol-Myers (BMY), Forest Laboratories (FRX), Johnson and Johnson (JNJ), Merck (MRK), Pfizer (PFE), Schering-Plough (SGP), and Wyeth (WYE). Now here is an interesting comparison of the price returns of the stocks and the returns that we have experienced by our focus on earnings and the use of price volatility (particularly the downward type) to increase or rebalance our holdings.

Company Symbol	Total Annualized Return*	Academy Annualized Return*	Difference
ABT	**1.53%**	**12.42%**	**10.89%**
BMY	**-6.22%**	**-0.56%**	**5.66%**
FRX	**4.96%**	**19.05%**	**14.09%**
JNJ	**1.86%**	**9.59%**	**7.73%**
MRK	**-2.41%**	**11.81%**	**14.22%**
PFE	**-5.11%**	**6.91%**	**12.02%**
SGP	**-5.38%**	**6.17%**	**11.55%**
WYE	**-3.88%**	**7.30%**	**11.18%**

*The market returns are computed for the period 4/1/2002 through 9/30/2006, inclusive of price, dividends and dividends reinvested in cash paying 2.5%. The Academy return is computed for the same period using a composite of client portfolios.

There are a few observations that we offer beyond the fact that drug stocks apparently have been unattractive since April 2002. Our investment discipline (and client patience) generated an average difference in return of 10.9%. This extraordinary difference in return was highly affected by price volatility. Merck, whose Vioxx courtroom forays have unnerved investors, had the highest volatility and the highest difference in return. Bristol-Myers, whose 5% dividend provided low volatility had the lowest difference in return. Clearly, our investment process is time-consuming. We are four years into the drug stock process and only now have gotten fully invested.

A Rip Van Winkle outlook on investing is important. Earlier we discussed the impact of share repurchases. In order for this strategy to payoff, a shareholder has to think in terms of multiple years and perhaps decades to realize value. This is difficult when the media trumpets results measured in minutes, days and quarters. Having spent three years

getting invested in them, we are not likely to sell our drug stocks soon. One of the curses of rapidly spiking prices is that should these stocks get “hot,” we would be forced by our discipline to reallocate, with nice short-term profits, but with a low likelihood of being able to rebuild a similar position soon thereafter. That is why not all public shareholders are enthusiastic about the tidy little profits being generated by the current private equity craze.

We hope this letter helps you understand why we’re cheering for low prices in most of our favorite companies. We want you to stay informed and feel comfortable about our investing discipline. In communicating, we try to “do unto others as we would want done unto us.” 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