October 11, 2010

Enclosed is your statement for the third quarter of 2010.

For the quarter, equity investors saw total returns of 11.29% for the S&P 500, 11.12% for the Dow Jones Industrial Average and 12.62% for the technology-oriented NASDAQ.
For the quarter, fixed income investors saw total returns of 0.23% for the 1-year Treasury Index, 3.19% for the 5-year Treasury Index, and 4.52% for the 10-year Treasury Index. The 10-year BB- corporate bonds had total returns of 6.56%. The quarter presented equity and fixed income investors with a recovery in prices as stronger segments in the credit markets resumed normal activity. But, for the weaker segments, deleveraging continues and credit is, for the most part, highly restricted. In many ways, we do not see a new pattern here, but only a return to the pre-21st century practice of lending to those who don't need loans. Our favorite example is furnished by the recent announcement that Microsoft is planning to borrow $4.75 billion, even though the corporation has over $36 billion in cash and short term investments.

During the past quarter, we continued to raise our cash. This, as we have said before, gives us as much joy as it does you. We realize that we are not paid to hold cash, particularly when cash is generating such stunningly low yields. But, the increased presence of cash does highlight two themes: 1) our traditional trimming of the positions in stocks whose prices have recovered more quickly than the underlying businesses and 2) a certain amount of redefining investment opportunities in this troubled environment. This quarter's letter addresses both.

As we have written before, and still firmly believe, navigating the universe of investments involves two all-important numbers: one representing price and the other value. Price is visible, precise and volatile; value is hidden, general and stable. Given our human tendencies towards the visible and precise, we all too naturally attend to price and related numbers such as price-earnings ratios or dividend yields. Such precision can give rise to confidence in areas where caution should prevail, in line with the old saying, "all that glitters is not gold."

Our goal is to determine the value. As prices change, we compare them to our evolving estimates of intrinsic values. During the past eighteen months, almost all stocks experienced a significant increase in price. As we compare value to price, it seems to us that the growth in the stock price of many companies has been disproportionate to their growth in intrinsic value. Price rises in the financial sector have most significantly outrun the recovery in value. In such cases, our response has been, as always, to trim positions and build cash – so in this respect, the cash buildup does not represent a departure from the past for us.

Throughout this economic crisis, we have been asked what we thought would happen. We do not consider our standard answer of "We don't know" to be embarrassing or the product of mushy thought. Rather, we think that agnosticism about the future helps us direct our attention to what we can know: the purchase of great investments at good prices. Our narrow investment focus does not mean that we ignore the larger economic environment. An example is the sales of our stock positions in AIG, Federal National Mortgage Association and MBIA prior to the mayhem of 2008. They resulted from our attention to "macro" issues, where we try to remove our portfolios from risks which would not be evident by only analyzing the competitive characteristics of a company or an industry.

Our increasing cash position results from this kind of attention. While we are not predicting bad times, we do want insulation against them. Again, this is nothing new. As one client commented, “You all have been building an ark for as long as I’ve known you!” We believe that the combination of a declining domestic currency, low domestic consumer confidence and increased government intervention make “paying down” for domestic companies prudent. While the U.S. economy is a powerhouse, having evolved rapidly over the past centuries, and will continue to innovate, growth rates are likely to slow dramatically in the absence of credit expansion.

Our response has been to increase our study of international companies and international business generally. For years, we had believed that we could find enough problems investing domestically and did not need to go overseas to find more! Accounting differences, cultural opaqueness and currency problems were just the starters for seemingly insurmountable obstacles to international investing. So why have we expanded our investment universe?

In contrast to the credit-constraints experienced in the U.S., overseas markets are able to extend credit from domestic savings as a means of expanding their economies. The companies which are able to serve these economies offer superior growth opportunities. Of course, this does not mean that we are only looking at companies based overseas. Walmart (formerly known as Wal-Mart, but rebranded in 2008) recently purchased the leading retailer in Africa. Such actions by U.S.-based companies fit our preferences.

Despite this redefinition within our investment universe, we still insist on getting “good prices,” which, because of the recent price increases, means that we may have to be patient. We believe that market turmoil is likely and that the investment opportunities created will be ample compensation for the painful holding of cash now.

We hope this letter helps you increase your understanding of our approach. 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