ACADEMY
CAPITAL MANAGEMENT

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In this letter we follow our occasional practice (adopted at the request of clients hoping for a little variety) of commenting on our investment process in broad terms, rather than sticking to a report on recent investment results, but an abbreviated investment report will follow the broad brush comments.

On a recent phone call, one of our younger clients asked a profound question, "How does your company continue to act like a group of eighty-year old men?" Given our youth-centric culture, that question might have been construed as a criticism. Our own preferred rule is "when in doubt, assume it's a compliment," so we decided to take it as a flattering reference to the caution and skepticism that comes with experience.

Our investment process is driven by awareness that "capitalism competes to zero profits." In his quest for profits in the early chaos of oil discovery, John D. Rockefeller termed his objective as "cooperative capitalism," also known as monopoly, but even his great Standard Oil Company could not rule forever. Since his day, the constant advances in science and consumer products have only increased the economic brutality of our system. The recent bankruptcy of the maker of Blackberry phones reminds investors of the true investment danger - competition. When a product is no longer cherished because a talented competitor (like Steve Jobs in this case) creates something that seems better, it is astonishing to see how rapidly economic demise sets in and how hard it is to recognize that the situation has changed, let alone foresee that change. We try to bear in mind that well-known adage of Keynes that there are two kinds of people: those who don't know the future and those who don't know that they don't know.

Within the world of investors "who know they don't know," investment consultants have generally split firms into either "value" or "growth." Both of these approaches are quantitative: "value" investors calculating the largest discount from their estimate of fair value and "growth" investors calculating the underpricing of dramatic growth. While both styles of investing are sound and candidates for superior results, we would rather go by the description of "nest egg" investor.

We prefer to use "value" as a discipline to protect ourselves from overpaying and give ourselves a margin of error, and "growth" as a sign that our investment enjoys some degree of advantage in the constant competitive struggle. The stock market is fairly forgiving of valuation mistakes which are not extreme. It can be much less forgiving of miscalculations of competitive advantage, as the Blackberry example illustrates, but the best and most enduring gains result from getting that calculation right.

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When you review the companies in your portfolio, we encourage you to think "why do they think this company will last?" Warren Buffet has defined this as looking for the "economic moat." Once we identify companies with characteristics that give it a durable competitive advantage, we can welcome the market's inevitable gyrations as means of providing opportunities to buy and, occasionally, to sell companies which have far surpassed underlying value.

Once in a while we get it wrong. That famous non-capitalist Mao Tse-tung once said, "it is far better to study one's failures than one's successes." In line with this, we reflect on our failures – both in omission and commission. The failures of omission are not permanent. When we identify a great firm but don't purchase it when the market presents an opportunity, we kick ourselves, but recognize that the market's gyrations will provide another chance down the road. It's not a strike until you swing at the pitch. However, failures of commission can be permanent and, as promised in last quarter's letter, we share where we missed the mark.

We had owned educational stocks for over a decade and most recently had purchased Apollo Group (University of Phoenix) and ITT Technical. Based on extensive research, we believed the difficulties of gaining educational accreditation and granting degrees creates a quasi-monopoly, shared by all colleges and universities, whether for-profit or not, that would have pleased John D. Rockefeller. The for-profit institutions had a further structural advantage, because they focused on adult learners poorly served by the nonprofit and state institutions. Even the revolution of the internet seemed fortunate for the industry.

By permitting the development of forms of distance learning ideal for adult students, the internet seemed to further enhance the business franchise of the for-profit institutions. Students did not even need to come to campuses; they could get on-line at home after work. We recognized that the nonprofit institutions could compete if they wished--many had experimented with forms of adult education and distance learning in the past--but believed they would not do so. Adult education is hard to fit into their traditional, campus-based structure. Among other issues, distance learning through the internet risks tarnishing their brand of exclusivity. So the for-profit schools, with little competition and with on-line learning leveraging their comparatively modest campus and fixed costs, prospered. Revenues rose, margins expanded and the stocks rose.

Then came the Great Recession, which unleashed a series of issues for all schools, but has had its greatest initial effects on the for-profits. On the federal level, student loan issues became prominent and resulted in tighter restrictions on that important source of revenue for the for-profits. At the same time, state funding for major state university systems caused those systems to try harder to develop on-line learning programs, using ever more powerful technology, to generate more revenues and replace the state funding they have lost. They have also created new campuses devoted exclusively to adult learners. Suddenly the for-profits, with increased federal pressure and real competition from state university systems, lost their quasi-monopolistic position.

Our error, at first glance, might seem to be missing the direct pressures the Great Recession would unleash on the for-profits, such as the tighter regulation of federal loan programs. However, as long as they served an important segment of the population that the traditional colleges and universities did not, we thought this kind of pressure would not be decisive. What we did not foresee was that the seemingly advantageous use of internet learning would allow state institutions to rapidly bridge the for-profits' moat in their search for the revenue lost in state cutbacks. Some of the for-profits are well equipped to meet the new pressures, but, as a group, they now seem to us "no place for eighty-year old men," and we have pared our positions.

We hope that this discussion has been relevant. In the spirit of our partnership, we want to provide insight into our process as if you are present at our investment committee – not just when we celebrate success, but when we are seeking to "make stepping stones out of stumbling blocks."

If you're new to Academy, past quarterly letters may be useful and may be obtained through your financial advisor or Margie Shelton 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