January 08, 2001

Enclosed are your statements for the fourth quarter of 2000.

For the quarter, equity investors saw returns of –7.8% for the S&P 500, 1.7% for the Dow Jones Industrial Average (DJIA) and –32.7% for the technology-oriented NASDAQ. These low returns were driven by a return to traditional concerns about profitability. For the year, equity investors saw returns of –9.1% for the S&P 500, -4.7% for the DJIA and –39.2% for the NASDAQ.

Normally, returns do not justify a discussion of mathematics. But, the returns of recent history have not been normal. Because returns are geometric and not arithmetic, they don't add up. If a portfolio is up 50% one year and down 50% the following year, surprisingly, the portfolio does not break even. Instead the portfolio is down 25%. To break even after last year's NASDAQ return, a portfolio needs to have been up at least 65%.

For the year, fixed income investors saw returns of 2.2% for the 1-3 year Treasury Index, 2.4% for the 7-10 year Treasury Index and 2.5% for the 10+ year Treasury Index. These positive returns were driven by expectations of slower economic growth and a decreasing supply of U.S. Government debt. However, corporate bonds of lower quality did not fare as well. For the year, 10 year BB- corporate bonds saw returns of –4.4.

This disparity between high quality bond returns and low quality bond returns is most troubling. The comparison of such returns is called a "credit spread." Credit spreads are widest during very low economic growth, as investors seek safety and flee risk. Yet, during this period of high economic growth, credit spreads have gone to recessionary levels, signaling problems created by a lack of concern about profitability. While "bubble" conditions have receded, the aftereffects remain.

As stated last quarter, we would prefer to see the stock prices of companies in our portfolios go down. Unfortunately, the problems in the stock market have not spread to the stocks in our portfolios. Thus, our good performance this year is a mixed blessing. Performance has been good for short-term wealth creation. Yet, long-term wealth is created by low prices so that we can increase our ownership in these stocks. Long-term wealth creation is what we aim for.

In last quarter's cover letter, we discussed some "brand" companies that we had purchased. These companies have extremely high corporate returns, low capital costs and long-lasting competitive advantages. As said, the past quarter did not present more of such pricing. But, everything has a season. The "credit spread" not only indicates where money is moving from, but where it is moving to. As U.S. Government interest rates go down, so do interest rates on home mortgages. We believe that long-term investment opportunities may be found here.

We will continue a patient, but attentive search for the purchase of excellent companies at prices significantly under their intrinsic value. As always, we appreciate the stewardship responsibilities you entrust to us.

Academy Capital Management