January 8, 2003

Enclosed are your statements for the fourth quarter of 2002.

For the quarter, equity investors saw returns of 8.44% for the S&P 500, 10.59% for the Dow Jones Industrial Average (DJIA) and 14.07% for the technology-oriented NASDAQ. These positive returns seem driven by investor excitement over government actions. The Federal Reserve dropped interest rates by 50 basis points, providing an "easy money" environment. Further, the federal government demonstrated a willingness to support the economy by increased deficit spending. Since the beginning of 1999, equity investors have seen annualized returns of -6.77% for the S&P 500, -0.65% for the DJIA and -11.39% for the NASDAQ. For comparison, equity-based investors of Academy have seen annualized returns of 7.02% since 1999.

As stated before, we pay attention to these benchmarks, the S&P 500 in particular. Over longer periods of time, ownership of the S&P 500 will provide a rate of gain in intrinsic business value representative of the economy. This is a reasonable rate. Our goal, and an important reason for our employment, is to provide a higher rate of gain of intrinsic business value for your portfolios. For this reason, we are including not only shorter measures of performance of the S&P 500, but longer ones as well.

For the quarter, fixed income investors saw returns of 0.63% for the 1 year Treasury Index, 0.31% for the 5 year Treasury Index, and -0.65% for the 10 year Treasury Index. As the Fed "cranks up the printing press," the shorter maturity bonds rise as short rates decline. On the other end of the yield curve, longer maturity bonds decline as long rates rise in anticipation of inflationary pressures. Consistent with the Fed's intent, investors were encouraged to take risk and 10 year BB- corporate bonds had returns of 6.22%.

With this reflationary activity, we continue to hold Treasury Inflation Protection Securities (TIPS) as an outstanding choice for fixed income investments, but are no longer buying them. It is worth reflecting on our change. When we bought these bonds in 1999, we were excited by the U.S. Government guarantee, the protection from inflation and the nearly 4% real return. To us, these qualities were highly desirable and the price was right. To others, protection of principal and protection from inflation seemed unnecessary. Those really were the good old days. Now that such protections are widely held to be desirable, the price is no longer right. Unless **both** high quality and good price are available, we don't get involved.

Similar pricing issues in stocks account for our inactivity this quarter. As we have stated before, the most critical factors in owning a stock are not general economic or market conditions; rather, they are the quality of the business and the price of the business. We are continuously searching for high quality businesses and found some over the past quarter. But what high prices!

Over the past three years, the stock market as measured by the S&P 500 has gone down 37.59% and yet our ability to buy stocks at reasonable prices has dramatically declined. This seeming contradiction indicates what is going on. Investors have moved from being risk-oriented to risk-averse without giving up on stocks. The S&P 500 represents a broad selection of the economy, with a wide range of risk. As an indicator of the higher risk component, the NASDAQ is down by 66.88% over the same three years. The reason for the S&P 500 being down almost 30% less than the NASDAQ is the presence of lower risk companies - some of whose values have actually risen.

Investors are now more willing to pay higher prices for businesses with strong balance sheets, actual earnings, understandable plans and dividends (more on this later). Such risk-averse behavior makes for a slower economy. The economy does much better when the "high-rollers" are investing. The current "easy money" environment is designed by the Federal Reserve and the U.S. Government to reward risk-taking and punish the risk-averse. So, if you are feeling bad about your low risk cash and bond positions, you were meant to.

While these "easy money" actions are taking hold, another problem is the excessive pricing of these lower risk stocks. As stated above, the only reason for the market not being much lower is because of strong valuations of the "old economy" companies (a phrase not heard much lately). When companies are forced to include stock options as expenses and to revise pension assumptions, earnings and valuations could be lowered significantly. The proposed tax advantage for dividends would encourage higher valuations at best and support valuations at worst.

We have rarely found that relying on a government's support of price levels is reliable. Ultimately, price levels arrive at mathematically sound and sustainable levels. With such currently high prices, you will notice a continuing high level of cash caused by the high prices of TIPS and quality businesses. As we've stated before, [**long time clients can skip this paragraph**], we do have cash in your portfolio. This causes us as much joy as it does you. We realize that you do not pay us to hold cash. But we have often said, "It's easier to get in a deal than it is to get out of a deal."

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