ACADEMY
CAPITAL MANAGEMENT

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During the past quarter, markets grew volatile and many stocks dropped in value, giving us a welcome opportunity to invest funds. After all, the last time we were able to do significant buying was the third quarter of 2011. Back then, we displayed our enthusiasm for lower prices by concluding our letter with "Every day is Christmas!" Once again, we have been in a shopping mode, taking advantage of lower prices by adding to existing positions and initiating new ones.

Since much of this new investment was related to currency movements, we decided to discuss them. In our third quarter letter, we have a tradition of addressing broader issues that go beyond specific portfolio holdings. The topic of currency movements, the changes in value of the world's currencies relative to each other, is probably more worthy of a book, but fortunately this is not an attempt to make anyone an expert in currencies (we sure aren't) but to shed light on their general impact on our investing process.

Currency movements affect us every day but remain mostly hidden. For example, the price of gas at the pump is frequently discussed in terms that have to do with the supply and demand of oil seemingly driving these prices. However, another underlying factor can even be more powerful – the relative strength of the US Dollar. When the dollar is strong relative to the currencies of where most of it is produced, the price of oil drops and vice versa. Even though we don't connect currency movements with the price at the pump, they do motivate our shopping patterns. When the US Dollar goes up, gas prices come down and we increase our gas consumption in response to lower prices.

Where currencies become visible is when we travel abroad. When we exchange money and use the exchanged money to purchase goods abroad, we quickly sense whether we are getting a good deal and see firsthand the impact of the exchange rate. Over time, travelers understand the currency lesson: when your currency is strong, it's time to go shopping abroad and when it's weak, it's time to stay home.

Currency exchange rates motivate these shopping patterns and provide a mechanism for "leveling the playing field" between countries by giving export advantages to the less fortunate or productive countries and by placing export disadvantages on the more

500 NORTH VALLEY MILLS DRIVE, SUITE 200
WACO, TEXAS 76714-0555
254-751-0555 P 254-751-0611 F
www.academycapitalmgmt.com

fortunate or effective countries. When a country's currency declines in value, it not only makes its own goods cheaper for the people of other countries, but also makes the goods of other countries more expensive for its own people so that they spend more at home. Despite creating a sense of declining wealth and increasing the cost of foreign goods for its own people, a declining currency gives its domestic businesses a boost and helps domestic employment.

These mechanisms can cause countries to intentionally manage exchange rates as an economic strategy. For example, after the Great Recession, the US had low rates of employment and was looking for ways to increase them. Weakening our currency was a means of increasing employment and it has appeared successful enough that other countries have employed the same strategy with "Abenomics" weakening the yen and "quantitative easing" weakening the Euro. As a result, the US Dollar is as high as it has been in years, causing US travelers to come home from abroad with much fuller suitcases.

We have often commented how applicable shopping instincts are to investing. A shopper applauds the decline in prices as way of finding value in goods in the same way that we applaud a decline in stock prices as a way of finding value in the stock market. Similarly, we believe that the shopping lesson above – when your currency is strong, it's time to go shopping abroad and when it's weak, it's time to stay home – can be applied to investing as well. As stock investing is more complex, the effects of currency movements can be more easily illustrated using an example from bond investing first.

Consider what would have happened to US investors if they had bought Japanese government bonds at different points within the last ten years. In 2006, the US Dollar could purchase 120 Japanese Yen. By 2012, the US Dollar had weakened and could only purchase 80 Japanese Yen. US investors who followed the "shopping rule" in 2006 and bought a 6-year Japanese Government Bond for $10,000 would have paid 1.2 million yen after exchanging their dollars for yen. In 2012 (disregarding interest payments), they would receive a maturity value of 1.2 million yen which would have increased to a dollar value of $15,000. A fifty percent appreciation in six years for investing in a safe bond is wonderful. But currencies can also go the other way.

By 2012, as a result of the deliberate policies referred to above, the US Dollar was weak and could only purchase 80 Japanese yen, but by 2015, due to a Japanese program of aggressive monetary expansion, the US Dollar had strengthened back to its 2006 value of 120 Japanese yen. US investors who ignored the "shopping rule" in 2012 and bought a 3-year Japanese Government Bond for $10,000 would have paid about 800,000 yen. At the end of three years, the US investor would receive a maturity value of 800,000 yen (again disregarding interest payments) which would have decreased to $6,666 – a loss of 33% in three years.

We do not want this example to convey the idea that currency movements are easy to assess or predict. It's a huge market with about $3 trillion of value traded daily. Currencies are cyclical with high unpredictability. But, just as the shopper overseas has a general feel of "expensive" or "cheap" so too do we find that a general assessment of "weak" or "strong" can be applied to currencies and used as an aid to investing.

This example does show how the "shopping rule" works when buying bonds. The reason it works is that as a bond investor, you are locking into an exchange rate for the entire period and "storing value". You are acting much like the shopper who recognizes that the "strong currency" is best spent abroad, while the weak currency is best left at home. As the current rush of US shoppers in Europe indicates, we think the dollar is strong now. But since we do not buy foreign bonds, our focus is more concerned with how this "shopping rule" applies to the stock market.

Importantly, when a country depreciates its currency, its stock market tends to rise and vice versa. As we described above, weak currencies tend to improve domestic economies by making those goods cheaper abroad. Adding to this, these foreign revenues are in a stronger currency which create currency gains as results are translated back into the domestic currency. This "double win" of business growth and currency gains improves the profit of businesses and the domestic stock market of the weakened currency loves it. Unfortunately, this means that when we go shopping for foreign stocks, the increased power of our dollar's rise is largely offset by the increased prices of those foreign stocks in their local currency.

While the shopping rule is thwarted in the stock market by offsetting price rises, some of these effects can help us find value from the dollar's rise, particularly in the case of US-based multinational companies. They are emerging from a period where the dollar was weak which improved growth rates. Part of the growth rate was a higher volume of sales due to its products being more competitively priced. But part of the growth rate was related to currency gains from the increased value of foreign holdings and profits. Since most of that tends to stay in the foreign currency, these translation earnings might be thought of as "ghost earnings" and should be adjusted for in valuation, although few do. Now, as the dollar strengthens, they pay a double price for their double win. They are challenged to operate at low costs overseas with their goods becoming relatively more expensive. In addition, their diminished revenues must be translated into stronger dollars. This "double loss" from business declines and currency losses hurts their growth. The same market that loves a double win hates a double loss and their stocks decline.

Here is where we see value with many US-based multinational companies. Just as we believe it is appropriate to exclude "ghost earnings" for valuation purposes in times of a weak currency, so too we believe it is appropriate to exclude "ghost losses" for valuation in times of a strong currency. Essentially, by excluding these ghost losses, the foreign assets and earnings of our domestic companies become bargain during periods of a strong dollar and allow us to go shopping indirectly through these companies.

We are finding a similar shopping opportunity in commodity-based businesses. Like the stock market overall, domestic commodity businesses tend to elevate with a weak currency. Just as our earliest example indicated, the price of commodities, like oil and gas, are strongly though invisibly influenced by the strength or weakness of the dollar. In times of a weak currency, commodities from overseas tend to rise in price. This looks like a bonanza for businesses that produce or service these commodities because revenues jump, causing investors to unknowingly violate the "shopping rule" and spend their weakened currencies on globally more expensive products.

We find that a strong currency allows the ability to purchase these commodity-related companies at bargain levels within the domestic stock market. For example, we have purchased companies in the oil and gas business. This is an area that we have not been interested in since 1999. At that time, the technology stock market was driving up the value of the dollar. As a result, oil and gas commodity prices dropped and related companies reached attractive levels. The same has occurred now. We think these companies are now bargains.

We hope that this discussion has shed some light on the impact of foreign currency movements and investment decisions in your portfolio. In the spirit of our partnership, we want to provide insight into our process as if you are present at our investment committee. Briefly returning to our investment report, we present the results of the third quarter of 2015.

As always, we appreciate the stewardship responsibilities you entrust to us and your patience with our investment process.

Academy Capital Management