ACADEMY
CAPITAL MANAGEMENT

January 27, 2016

Enclosed is your statement for the fourth quarter of 2015.

Past observers of the above chart will notice something else: 2015 was the third consecutive year in which the latest five-year average return of the S&P 500 was higher than ours. One of Academy's longstanding fans suggested that we just remove this unfavorable comparison. We are not going to do so, but feel it's pertinent to discuss why we include these and whether or not we are pleased with our results.

Initially, we did not include benchmark comparisons in our quarterly letters. We believe that stock market volatility tends to be noisy and provide little information. Stock market volatility is the smart investor's friend though; it allows the purchase of excellent companies at sound prices. But the siren call of price movements causes many investors to make poor decisions.

A recent Wall Street Journal article described an example of a well-known fund that delivered an 18% per year return for the decade ending 2009. However, during the same period, the average investor in that fund lost 11% per year by adding money at higher points and withdrawing at lower levels. While this 29% per year "human behavioral tax" is an extreme example, studies show that investors cost themselves nearly *2% per year* by moving in and out of funds. By presenting and discussing comparative returns, their lures and their pitfalls, our hope is to reduce that cost.

The root challenge of stock market prices is their variance from the "intrinsic" value of their underlying businesses. This gap creates a sense of danger and excitement and is the stuff of daily news. But these price variances also occur in multi-year longer term patterns that we term "stock market cycles." While there is no precise definition of a stock market cycle, we view it as comprising at least two periods: a "bull" market and a "bear" market. We basically define a bear market as a period beginning with a "top" and ending with a "bottom" – with the bottom being at least 15-20% lower than the top. A bull market is just the reverse. Notably, these periods are only definable after the fact.

Basically, bull markets are driven by a collective psychology making a bad day okay and a good day awesome. In a bear market, the reverse is true: good days are okay and bad days are awful. Governments have long attempted to control and reduce these market cycles, but have so far been unsuccessful in discovering a drug, remedy or central banking action for what amounts to a crowd mood disorder. For better or worse, that's the world we live in. To navigate these cycles, as we have warned in these letters, is *simple, but not easy*.

Discussions of our comparative results are designed to ease the navigation of these market cycles. Because what glitters is not always gold, we believe that investment results need to be judged over a full market cycle. Taking an example in the chart above, it is evident that investors endured a nearly three-year bear market from the first quarter of 2000 through the fourth quarter of 2002. Then a bull market ensued which ended five years later in the fourth quarter of 2007. This full market cycle shows a pattern: in the bear market, our carefully priced investments had superior results and, in the bull market, our calculators seemed ineffective as our investments had inferior results *every single year* in 2003, 2004, 2005, 2006, and 2007.

We are now in the midst of another full stock market cycle, and, so far, the pattern is similar. Starting in the fourth quarter of 2007 through the first quarter of 2009, we experienced a bear market in which our investments delivered superior results. But since then, we have been in a bull market in which our investments have delivered inferior results *every single year* in 2010, 2011, 2012, 2013, 2014 and now 2015. We are nothing if not consistent!

Putting this information into a chart highlights some facts that we wish our clients to understand. First, bull markets *last longer* than bear markets with bull markets lasting, on average since the 1930s, three and a half years and bear markets lasting a year and a half. (The historical average of a full cycle of five years is what we chose as a comparative measure in our chart, even though the last cycle and the current one are at least eight years long.) Second, our results tend to be inferior in bull markets and superior in bear markets. Third, the combination of long bull markets and inferior results in these markets means that we experience inferior results *more frequently*. Fourth, and most importantly, over a full stock market cycle we have experienced superior results. The superiority of this "better in bad, worse in good" combination, (though "past results cannot guarantee future returns") seems to be rooted in two parts: mathematical and behavioral.

We have commented in previous letters that investment results are geometric not arithmetic. By "geometric," we describe a mathematical sequence that is cumulative or multiplicative rather than additive. Strange things happen in the "geometric" world as positive results are compounded and negative results are magnified. For example, if over the course of two years, a portfolio is +50% one year and -50% the other year, the result is not 0%. If investment results were arithmetic (additive), it would be. But, because investment results are geometric (that is they compound), the result is -25%. This underlying math is at the root of the superiority of "better in bad, worse in good" results.

But the behavioral reason is just as important as the mathematical, if not more so. The primary characteristic of market cycles is their contagious quality; agreement tends to build. This is incredibly dangerous to investors. Within a bull market, the agreement moves from "stocks are better" to "these particular stocks are better" as a bubble forms. Within a bear market, the agreement moves in reverse from "these stocks are bad" with a bubble breaking to "all stocks are bad." The reason this pattern is so hard to resist and a bubble is so hard to detect is because of the increasing universality of agreement.

As an aside, mechanics of these feedback loops are similar but the specifics are different in each market cycle. In the latest bull cycle, the positive feedback loop was around highly leveraged financial institutions, the real estate to which they were levered and the financial instruments employed. The prior cycle focused on business disruptors that participated in the revolutionary technology of the internet in which investment was simple - as a client recommended, “Just buy the stocks that are splitting!”

We continuously search for possible feedback loops. Our candidate for a positive feedback loop in the current bull market is the huge movement into passively managed funds. The Wall Street Journal reports that, in 2015, over $200 billion moved out of actively managed funds while $400 billion moved into passively managed (indexed and ETFs) funds. Since the makeup of many of these funds is dictated by the relative capitalization of the underlying stocks, we believe that a distortion is developing around the “popular” large market capitalization companies. As investors abandon active management for management by a committee and a computer, a rebalancing is taking place. The sale of smaller, less popular holdings held by active managers drives their prices down and lowers their index weighting. The purchase of larger, more popular holdings drives their prices up and increases their index weighting. One study indicated that within the S&P 500, the return, exclusive of dividends, of the largest 20 companies in 2015 had an average return greater than 55% while the return of the smaller 480 companies was down, on average, nearly 5%. If this classic bubble pattern of narrowing strength is a guide, this loop will continue indefinitely until it pops with mayhem.

The only defense against participating in these loops seems to be a calculator employed to distinguish price from value. Interestingly, as investor agreement becomes more universal during a cycle, a calculator’s usefulness seems to diminish as it discourages the purchase of the most popular investments in a bull market. This results in a “worse in good” part of the cycle. In a bear cycle, a calculator seems self-destructive as it encourages the purchase of unpopular investments in a bear market. Yet, this drives the “better in bad” part of the cycle. By following the precepts of the calculator rather than the crowd, “value” investors (thus the calculator-based term) build superior wealth.

Two psychological perils for calculator-based investors lurk in this “simple but not easy” universe of investing. The first is to give up on the discipline in the bull market phase because it is “underperforming.” The challenge to not do so is more difficult than it would appear. Studies have shown that poverty is not as difficult on health and happiness as relative poverty is. When others are getting richer, it is incredibly challenging to not imitate. As a reminder to ourselves, we have a Barron’s magazine cover at the end of the 1994-1999 bull market that pictures Warren Buffett with a headline “What’s Wrong, Warren?” in which the text theorizes that he “lost his magic touch.” If a revered financial publication can get it that wrong, the rest of us can too.

The other peril is to panic in a bear market, by either selling everything or freezing up and resisting the purchase of new investments. We share the sentiment of one “value” investment fund’s bear market brochure that pictures a thoroughly disgusted child looking at his plate with a caption that reads, “Now is the time to eat your vegetables”. If volatility is a smart investor’s friend, a bear market is the smart investor’s *best friend* (or better yet, BFF as millennials might put it). We have no idea if we are in the early stages of a bear market; we may be. We have been finding an increasingly wonderful opportunity set as unpopularity spreads and popularity narrows. For new clients, this means that we are investing your low-yielding cash. For clients with more fully invested portfolios, we are in a process of replacing more popular stocks with their less popular brethren. If nothing else is clear from this letter, it should be that our investment discipline relies on bear markets. They provide wonderful investment opportunities to build long term wealth. We have seen this movie before. Painful as it is to "underperform" in a bull market, we are pleased with our results and hope this letter sheds light on the reasons why. A contrarian discipline is only worthwhile if investors can stick to it throughout cycles. We are extremely fortunate in having a patient, full cycle investor base and hope we keep you well-informed.

Our standing fourth quarter tradition has been to discuss stocks we have sold in the prior year as a means of explaining our investment principles. We will add this discussion to the next quarter's as the present letter is longer than usual. 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

Government regulations also require us to send the enclosed copy of Academy's Privacy Notice and to make available a copy of our updated Form ADV - Part II (our regulatory filing with the SEC). If you would like one, please contact Robert Stovall at our office.

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

Academy Capital Management