April 19, 2005

Enclosed are your statements for the first quarter of 2005.

For the quarter, equity investors saw total returns of -2.15% for the S&P 500, -2.06% for the Dow Jones Industrial Average and -7.95% for the technology-oriented NASDAQ.

For the quarter, fixed income investors saw returns of 0.21% for the 1-year Treasury Index, -1.56% for the 5-year Treasury Index, and -1.25% for the 10-year Treasury Index. The riskier 10-year BB- corporate bonds had similar returns of -1.34%. These low bond returns were in response to the Fed's continued rate raising campaign.

The annual reports of most CEOs are quick to point out their successes, but almost never their failures. In contrast, Warren Buffett regularly reports his mistakes to his shareholders and summarizes them once every twenty-five years. We believe such honesty has been an essential part of his success. We find the process of identifying our mistakes critical to our growth and have committed to honestly report them to our "stakeholders" every five years. Here, we summarize them in the spirit of the adage "be a judge, not a lawyer."

There were two times that we did not work hard enough. The first was when we did not invest in Progressive, thinking its earnings history "too good to be true." Progressive had long outperformed its peers. Then in 1999, widespread mispricing became clear in the insurance industry and Progressive was the first to take a sizeable hit to earnings. We saw this as the beginning in a series of restatements for Progressive. We could not have been more wrong. Had we dug deeply enough, we would have seen that Progressive had a history of owning their mistakes early and completely. So those times when Progressive takes an earnings hit become a rare opportunity to buy their stock at a good price. Our second error in a similar vein was when we did not buy United Technologies after its stock declined due to the terrorist attacks in 2001. Here we simply had not done our homework in time. The stock price had been so far away from the price at which we would even consider it that we did not have adequate research prepared. The stock went down, but too briefly. By the time we did the necessary research, it had risen out of our range again.

Another time we short-sightedly yielded to the temptation to lock in a gain. After identifying Medical Assurance (now Proassurance) as the superior medical malpractice insurer, we waited for it to come within our buying range and were "blessed" with an industry-wide crisis. We promptly purchased and expanded our ownership as the price dropped. However, the company made a share buyback offer that would create a short term guaranteed return, and we bit. A bird in the hand might be worth two in the bush, but, as we found here, not four. We still own shares, but at a painfully reduced level.

Another time we acted impatiently. Our preference is to avoid times when one company has troubles, but purchase in the face of industry problems. When an individual company exhibits problems, their own industry competitors turn on them, hoping to divide up the wreckage. However, when an entire industry experiences problems, a "circling of the wagons" occurs. The industry acts in unison against other competitive forces and can be very successful. Further, by waiting until an entire industry is really pressured, we find that even the best companies become cheap and develop into superior candidates for a long term hold. Despite full awareness of this, as the pharmaceutical industry came under fire, we impatiently began our purchases with Bristol-Myers Squibb and Schering-Plough, both good companies, but should have waited for Pfizer, Merck and Johnson and Johnson, the best in the industry.

Owning these mistakes forced us to change. First, we are more willing to do careful research on outstanding companies, even if the prices appear permanently high or if the earnings seem "too good to be true." Second, we are less likely to sell a great company, even at a reasonable price. A business owner would not sell an excellent business for anything less than a high price; nor should we. Finally, and this one is more difficult than some might imagine, we are working to be patient. Sometimes a rising stock market, a cheerleading Federal Reserve chairman and the presence of cash (or TIPS) combine to put real pressure behind a natural desire to invest. Putting an emotional buffer between us and cash awaiting investment is often the most difficult part of investing.

With those mistakes in mind, we conclude on a final note. We do not agree with those who say that the careful application of our valuation principles on a company-by-company basis has been a mistake, although it has prevented a lot of our cash from becoming invested. This entire period has been one of historically high valuations, held aloft by the capable efforts of our Federal Reserve chairman, Alan Greenspan. Such levels will not always hold and we are pleased that our results have been achieved in a way consistent with our valuation principles. While "past results are no guide to future performance" as the prospectuses say, we are pleased to report that even though technology stocks collapsed and investment fraud was widespread during the past five years, we had no permanent losses from the stocks we purchased. The avoidance of significant losses is critical to our mission of providing superior performance to the S&P 500 while concentrating on safety of principal.

As always, we appreciate the stewardship responsibilities you entrust to us.

Academy Capital Management