April 11, 2012

Enclosed is your statement for the first quarter of 2012.

For the quarter, equity investors saw total returns of 12.59% for the S&P 500, 8.84% for the Dow Jones Industrial Average and 18.98% for the technology-oriented NASDAQ. For the quarter, fixed income investors saw total returns of -0.0013% for the 1-year Treasury Index (a "zero percent world" requires detailing returns to the ten thousandth percent!), 0.52% for the 5-year Treasury Index, and -2.20% for the 10-year Treasury Index. The 10-year BB- corporate bonds had total returns of 3.60%. The sizeable equity, but meager fixed income returns reflect a collective sigh of relief that, at least for now, the prospect of a Greek bankruptcy and a subsequent global contagion have been averted. While we are skeptical about the ability of Greece to avert bankruptcy, we do not view the contagion risk to be nearly as significant as the issues related to the declines in U.S. property values. As a result, we will continue to be opportunistic in the likely event of more bad news coming from the Eurozone.

At Academy, we believe the best investment opportunities exist in difficult periods. The recent rise in prices slowed our shopping considerably, causing your portfolio to increase its cash holdings (money market funds and U.S. Treasuries). We realize we are not paid to hold cash, particularly since the level of today's yields on cash are so low as to appear a computer error. The aforementioned Eurozone issues, a U.S. presidential election and incipient currency wars should provide us with enough uncertainty for some excellent purchases.

The spring quarter's letter regularly addresses the businesses of the stocks which were newly purchased over the prior year. By that time, dust from the prior year's activity has settled, stories have moved from the headlines to the back page and we can reasonably discuss the characteristics of these new additions. Before we discuss them, it is important to note that because we manage individual portfolios but write a general letter, not all of these stocks may be in your portfolio.

The past year's purchases bring to mind the comment of John Kenneth Galbraith, a Canadian-American economist who stated "Faced with the choice between changing one's mind and proving that there is no need to do so, almost everyone gets busy on the proof." We are no different. We are interested in the purchase of great companies at reasonable prices, where we have stubbornly defined "great" as a huge competitive advantage created by some form of consumer monopoly, such as a brand. In capitalism's relentless competition to zero profits, we seek safety in these narrowly defined competitive advantages. The companies which we sold in 2011 all exhibit this "brand" power (and provided nice gains). In alphabetical order they were: GlaxoSmithKline, Hershey's, Moody's and Time Warner. But in 2011, we "changed our mind" and broadened the definition of competitive advantages with which we are comfortable, resulting in the addition of some companies that doesn't seem very "Academy-like" (at least at first glance).

In alphabetical order, they were: Citigroup, ConocoPhillips, Google, Omnicom and Total.

NY, NY-based Citigroup (C) is a diversified financial services company with operations in consumer and corporate banking, insurance, investment banking, and asset management. Citicorp started as the First Bank of the United States, founded in 1791. The New York branch was failing and, in 1812, Colonel Samuel Osgood, the nation's first postmaster general and treasury commissioner, reorganized it as the City Bank of New York in 1812. Only two days after the bank received its charter, on June 16, 1812, war was declared with Britain. Talk about the Fed coming to the rescue! C has had many ups and downs during the past 200 years, but has managed to survive and grow. We have never purchased stock in banks, because of their highly leveraged balance sheets. However, the stresses of the past few years created well-capitalized bank balance sheets, raised the barriers to entry against newcomers, repositioned U.S. banking more securely and lowered share prices to compelling value.

ConocoPhillips (COP), an integrated oil and petrochemicals company with assets across the globe, was formed on August 30, 2002, when Phillips Petroleum acquired Conoco. The predecessor company, the Continental Oil and Transportation Company was created on November 25, 1875 by Isaac Elder Blake in Ogden, Utah. Desperate for money as a result of numerous speculations gone wrong (beginning by losing his college savings on two oil stocks!), Mr. Blake innovated with oil railcars and brought low cost kerosene to Utah residents. COP grew through a series of acquisitions and mergers, but its assets remaining highly U.S.-based. Like banking, we at Academy have never purchased a stock in the oil and gas business. For years, people have marveled that a Texas-based money management firm wouldn’t have investments in this area. However, commodity-based investments have too little of those competitive advantages we seek. Yet costs for exploration have risen to the point where “underground” creates a competitive advantage allowing us to make our first investments in this area.

Google Inc. (GOOG) is a global technology company whose stated mission is to organize the world's information and make it universally accessible and useful. GOOG was founded by two college roommates, Larry Page and Sergey Brin, who were interested in solving mathematical problems. Their solution, first called BackRub, but later Google, to the “search” the internet made them both wealthy and influential. The company was created in 1998 and went public in 2004. As shown in the paragraphs above and prior letters, at Academy we prefer companies with long histories as one measure that the brand or business advantage is well-established. GOOG, on the other hand, is not even as old as Academy (a first for us)! However, in a short time, Google has established itself as a dominant brand so that it references its own category, like using a Kleenex (or for old timers, “Xeroxing” a paper). Even more significant, we have studied the failed attempts of well-capitalized competitors to take even one percent of “search” from GOOG.

Omnicom Group, Inc. (OMC), the second-largest advertising company in terms of worldwide billings, is composed of several powerful agencies: BBDO Worldwide, DDB Needham Worldwide, and TBWA Worldwide. For the past century, these agencies have been developing those maddening jingles and catchy slogans we often wish we could forget. OMC has been on our wish list for years because advertising is critical in building the consumer monopolies we seek. The agency business has extraordinarily high returns on capital, indicating the high value they are perceived to add. Unlike the other companies of the Purchased Class of 2011, OMC did not require any broadening of our thinking.

Total, S.A. (TOT), an integrated oil and petrochemicals company with assets across the globe, was formed by combining the three largest French oil and gas companies. TOT is truly an extension of the French state, started in 1920 as a response to nearly running out of fuel in World War I. Unlike the U.S. and Great Britain, France did not have a well-developed corporate structure for accessing energy supplies through its colonies and protectorates. Over time, French policy facilitated aggressive development of controversial finds. While COP is the “stay at home” oil and gas company, TOT has been the most aggressive in global attempts to discover energy supplies. Controversy in this area has given opportunities for purchase at low prices. And, as with COP, “underground” assets have become increasingly difficult to attain, creating an expensive barrier to entry for newcomers.

These companies are representative of the breadth we hold in our portfolios. In 2011, we increased that breadth. Some are huge; some not. Some are global; some not. Some pay dividends; some don’t. Some are widely diversified; some not. But there is a common thread in these businesses – each of them was built to and continues to address an important societal need. We take pleasure in the unique strengths that these companies have generated. The wild movements of the market are much less stressful when our attention stays on the focus, dedication and commitments of our portfolio companies. This is also the reason why we are pleased when market downturns allow us to increase our ownership at better prices.

We hope this letter helps you understand our process. We want you to stay informed and feel comfortable about our investing discipline. If you’re new to Academy, past quarterly letters may be useful and may be obtained through your financial advisor or Sue Compton at our office. In addition, our website (at www.academycapitalmgmt.com) has our investment reports on the individual holdings in your portfolio.

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

Academy Capital Management