July 11, 2001

Enclosed are your statements for the second quarter of 2001.

For the quarter, equity investors saw returns of 5.9% for the S&P 500, 6.7% for the Dow Jones Industrial Average (DJIA) and 17.6% for the technology-oriented NASDAQ. These positive returns were driven by investor optimism over the aggressive rate cutting of the Federal Reserve. Historically, rate cuts have been extremely beneficial to the stock market. For the last twelve months, equity investors saw returns of -14.8% for the S&P 500, 2.1% for the DJIA and -45.3% for the NASDAQ.

Again, a review of portfolio math is relevant due to the extreme returns of recent history. Portfolio returns are geometric and not arithmetic, meaning they don't add up. For example, if a portfolio is up 50% one year and down 50% the following year, the portfolio, surprisingly, does not break even. Instead the portfolio is down by 25%. To break even after the last twelve months' NASDAQ return, a NASDAQ portfolio needs to increase by close to 100%! Investors who reflect on this will feel the same small pleasure that some of us felt on learning the truth about Santa Claus, the tooth fairy and the stork: at least we know something that others don't know.

For the quarter, fixed income investors saw returns of 1.16% for the 1-3 year Treasury Index, -1.03% for the 7-10 year Treasury Index and -1.74% for the 10+ year Treasury Index. These returns were created by the increased liquidity provided by the Fed, as rates were reduced three times for a total of 125 basis points or 1.25%. Increased concern about inflation was the cause of negative returns for long-term bonds and provided excellent returns for holders of Treasury Inflation Protection Securities. Year to date, the Fed has dropped rates by 275 basis points or 2.75%. In line with such increased liquidity, one might expect lower quality corporate bonds to do well. However, for the quarter, 10 year BB- corporate bonds saw returns of -3.69%, reflecting the poor lending decisions in last year's euphoria. As we commented in last quarter's letter: "liquidity is up and profits are down; the bubble has popped and the aftereffects remain."

We also stated that we would prefer to see the stock prices of most of the companies in your portfolio go down. While we are pleased with the purchases we have made, we could further increase our long-term returns with better buying opportunities. Most investors look for buying at the "bottom." We are simply looking for outstanding investment opportunities, regardless of short-term price movements.

Unfortunately, once again, the problems in the stock market have not spread to the stocks of companies in your portfolio because the companies in your portfolio are generating nice profits. Until the market resumes an ignorance of profits, we will have limited opportunities. Thus, your portfolio's good performance this quarter was a mixed blessing. This performance is good for short-term wealth creation and the moods of our clients. Yet, long-term wealth is created by low prices so that we can increase your ownership in these stocks. Long-term wealth creation is what we aim for.

In last quarter's cover letter, we shared that declining U.S. Government interest rates would tend to drive down mortgage rates. Increased liquidity ought to stimulate consumption, since most people buy a payment, not an asset. We continue to believe that long-term investment opportunities may be found here.

In addition, we are diligently analyzing ways to profit from another major opportunity. It appears that a bubble continues to develop in the U.S. Dollar. As a result of such strength, outstanding companies (truly men among boys) such as Coca-Cola, Gillette and Merck are showing weak earnings. The thought of purchasing such companies at mathematically sound levels is almost breathtaking (such is the limited range of excitement at Academy).

In order to maximize such opportunities, we do have to hold some 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. However, to act quickly, we must have cash on hand. Warren Buffett once commented that it was no fun having cash burn a hole in his pocket, but after overpaying for a stock he determined that it was much more fun than having that cash burn a hole in someone else's pocket.

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