July 13, 2005

Enclosed are your statements for the second quarter of 2005.

For the quarter, equity investors saw total returns of 1.37% for the S&P 500, -1.63% for the Dow Jones Industrial Average and 3.07% for the technology-oriented NASDAQ. For the quarter, fixed income investors saw returns of 0.83% for the 1-year Treasury Index, 2.83% for the 5-year Treasury Index, and 5.41% for the 10-year Treasury Index. The riskier 10-year BB- corporate bonds had similar returns of 2.76%. These positive bond returns reflect a belief that the Fed's continued rate raising campaign will be successful in stemming inflation.

During the past quarter, we purchased positions in Forest Laboratories and Wal-Mart. Both of these companies are the kind we like. In past letters, we have often discussed what kind of companies we look for (for such letters, contact Sue Compton), but not how we go about valuing them.

When it comes to valuing companies, our guiding principle is those three famous words, "margin of safety." The disciplined application of these words reduces the likelihood of an emotion-based investment decision. In order for a company's stock to increase in value over time, the "intrinsic income" of the company must grow commensurately. For us, valuation begins with understanding the "intrinsic income" of the company (or as one client says, "the **real** money"). Just as bonds are evaluated for the income from coupon payments, so ultimately do we evaluate stocks based on the company's "intrinsic income." What we mean by "intrinsic income" goes beyond dividends and even well beyond earnings in the usual sense.

In our third quarter letter of 2003, we wrote, "all earnings are not alike in value, even if they are identical in amount. Some businesses require the reinvestment of earnings, and some do not. There is no accounting for this distinction. We much prefer to own businesses which do not, for competitive reasons, require the reinvestment of earnings and whose earnings are truly available for shareholders, even if the business chooses not to pay them out. We have therefore created a concept of "intrinsic income" to designate the regularly recurring earnings stream that is truly allocatable by the management to either dividends, stock repurchases, acquisition or for reinvestment in the business."

Our goal, then, is to build a portfolio of companies which have significantly higher "intrinsic income" ten years and further out so that our clients may increase their spendable income. We recognize that "intrinsic income" does not immediately result in money in our clients' pockets except in the rare cases of companies that pay out maximum dividends. However, "intrinsic income" does represent the ability of the company to drive sustainable growth and, thus, appreciation in stock value.

The ways in which earnings have been created also give clues as to the presence or absence of "intrinsic income." Many companies grow earnings by a series of acquisitions. Often, those companies are later split into smaller pieces as the earlier, hoped-for synergies do not pay off. Instead, as a friend of ours said during the bursting of the Texas real estate bubble “my good deals just feed my bad ones.” The result is a company without “intrinsic income” as a whole even though certain parts may generate it. In a way equally unattractive to us, companies often grow earnings by issuing more shares as a source of capital for rapid growth. It is unclear until the inevitable slowdown occurs whether the business has what we call “intrinsic income.” So the companies which build organically, by either reinvesting their earnings within areas of existing competence at higher than average returns or by paying them out to shareholders are easily the most interesting to us.

Once we have determined the level of “intrinsic income” and the probable rate of growth, we then work to compute a stock purchase price which is likely to produce a 15% rate of return over a long period of time. This desired rate of return helps us create the “margin of safety” to deal with inflation, general calamities and specific business surprises. While such a desired rate may seem excessive, particularly in light of the high quality of the companies we purchase, we believe that our environment currently has embedded in it more risk than is evident. As was wisely stated, “things are never as good or as bad as they seem.” And, right now it seems to us that things are not as good as they seem. Despite these continuing concerns, the market continues to provide us with excellent opportunities, like Forest Laboratories and Wal-Mart, to purchase companies that generate “intrinsic income” at prices that provide us our required “margin of safety.”

As always, we appreciate the stewardship responsibilities you entrust to us and hope this letter helps gives you a better understanding of our investment process.

Academy Capital Management