July 8, 2011

Enclosed is your statement for the second quarter of 2011.

For the quarter, equity investors saw total returns of 0.10% for the S&P 500, 1.42% for the Dow Jones Industrial Average and -0.03% for the technology-oriented NASDAQ. For the quarter, fixed income investors saw total returns of 0.18% for the 1-year Treasury Index, 3.26% for the 5-year Treasury Index, and 3.55% for the 10-year Treasury Index and the 10-year BB- corporate bonds had total returns of 1.37%. "Derisking" was heard more frequently, as concerns grew over weaker European economies, signs of inflation and the impact of the "Arab Spring." Despite increased anxiety, investors were reluctant to move to "safety" by increasing cash holdings which pay punitively low yields. Instead, the quarter's results indicated a movement towards "quality" in both the equity and fixed income markets. Our portfolios, focused on quality companies, benefitted despite our significant cash holdings.

Before moving to our second quarter's customary discussion of the earnings growth of the companies that formed the bulk of our prior year's investments, we wish to address this "cash" issue. As we have written frequently over the years, cash is a four-letter word and is not our preference. We realize that it is painful to hold cash and even more painful to pay someone else to hold it for you. The cash we currently hold is not simply a function of high prices; in fact, by our standards, the large cap equity market would appear reasonably priced. But we also think our usual methods of pricing investments is more prone to error when demand for goods, products and services is sustained by deficit-financed government spending and when demand for investments is manipulated by artificially low interest rates. Given that both conditions exist, the cash we hold reflects an additional "margin of safety." We are neither forecasting nor hoping for bad times, we are simply preparing for their possible arrival.

As we have written previously, we look for long-term (10 years or more) aggregate earnings growth of 6-8% per year in the companies we hold in our portfolios. Earnings growth is what ultimately drives market value growth. During 2010, we held the following companies for the entire year. We have listed the changes in their year over year earnings per share (EPS) changes in percentage terms after the company names:

Company	**% Change in EPS***
Allstate Insurance	-18%
American Express	117%
Becton, Dickson & Co.	-0.2%
Comcast	3%
Hershey Foods	16%
Intel	166%

Johnson and Johnson	3%
Legg Mason	23%
Masco	-37%
McGraw-Hill	14%
Microsoft	30%
Moody's	27%
Nestle Sa	-1%
Philip Morris	20%
Procter & Gamble	-1%
Sysco	12%
Time Warner Cable-A	19%
Unitedhealth Group	26%
Wal-mart	11%

*For EPS, we have used Value Line's most recent numbers. These EPS represent Value Line's best attempt at a description of after-tax operating earnings per share.

After weighting the results for the size of our holdings, the average *increase* in the EPS of our stock holdings was 20% last year. Just as in other years, the average reflects some industry-specific issues, but with due allowance for issues of this kind 2010's results were unusually strong, driven by a combination of depressed 2009 earnings and by generous governmental spending initiatives that continue to offset the contraction in credit in the private sector.

We highlight earnings regularly, because it puts the focus on the underlying business rather than the stock price. Earnings are generally less volatile than stock prices, but vary widely when studied annually as we do in our letters. For the last three years, however, earnings moved more widely than the market. As a result, we wish to share with you how we think about volatility in earnings. As a repeat of last year's discussion, for those not inclined to repetition or such detail, simply skip the next three paragraphs and remember the motto, "things are never as good or as bad as they seem."

In prior letters, we have stated that price volatility is the norm in the stock market and stressed how important this volatility is for our investment process. Without Mr. (Stock) Market putting his goods on sale, we would not be able to make bargain purchases. Similarly, earnings volatility is the norm of the business world and is important to our investment process.

An astute investor once said, "buy the assets and sell the earnings." This short phrase highlights that businesses have productive capacity from which earnings are generated. This productive capacity is expensive with many "fixed costs" to keep that capacity in place. Every dollar of sales above the fixed costs is highly profitable, making the last dollar of sales the most important. In this way, small changes in sales can lead to large changes in earnings.

Many investors, in their quest for simplification, forget this. By focusing only on good earnings and the related ratios, they purchase businesses which are operating closer to full capacity. Even worse, these investors are purchasing businesses at full capacity when these businesses are most pricey. For this reason, we pay careful attention to measures beyond earnings, such as sales, replacement values, historical valuations and business components. Yet, over longer periods of time, earnings growth is the primary driver of market valuations.

We also attempt to discern the sources of earnings and their likely continuation. So, while over longer periods of time, earnings growth is the primary driver of market valuations, the significant increase in earnings over the past year, considered in isolation, may overstate the rise in business values. To avoid this potential overstatement, we have increasingly invested in companies whose global exposure seems less directly exposed to government support and, thus, more likely to sustain growth.

As stated in the 2001 Berkshire Hathaway annual report: "when the tide goes out, you'll know who's swimming naked." Close earnings' scrutiny and care in spending our cash holding are our best attempts at swimsuits, when the tide of government support leaves our shores.

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