July 13, 2012

Enclosed is your statement for the second quarter of 2012.

For the quarter, equity investors saw total returns of -2.75% for the S&P 500, -1.85% for the Dow Jones Industrial Average and -4.76% for the technology-oriented NASDAQ. For the quarter, fixed income investors saw total returns of 0.04% for the 1-year Treasury Index, 1.89% for the 5-year Treasury Index, and 5.78% for the 10-year Treasury Index and the 10-year BB- corporate bonds had total returns of 2.23%. The investment return on the low-yielding (around 1.5%!) 10-year Treasury Index is eye-catching and, to us, ominous.

We wish to address this concern 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. For the past several years, investors have favored "safety" assets, choosing bonds over stocks and dividend-paying stocks over non-dividend payers. This "bird in the hand is worth two in the bush" outlook is understandable. However, the cumulative result of several years of such thinking has created a dangerous mispricing that we have come to regard as a "bubble" of sorts.

"Bubbles" occur when excess liquidity finds a fashionable asset. Global central bank efforts to force investors out of cash has been met with a herd-like preference for miniscule bond yields and stocks which pay dividends, regardless of the underlying earnings. Given these conditions, the cash in your account reflects an additional "margin of safety." We are neither forecasting nor hoping for bad times, but 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 2011, 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***
Abbott Labs	12%
Allstate Insurance	-53%
American Express	22%
Apollo Group	-8%
Becton, Dickinson & Co.	14%
Citigroup	3%
Comcast	22%
Intel	17%
ITT Educational	0%
Johnson and Johnson	5%
Legg Mason	-6%
Masco	-86%

McCormick	5%
McGraw-Hill	8%
Medtronic	2%
Microsoft	28%
Nestle Sa	14%
Philip Morris	24%
Procter & Gamble	11%
Sysco	-2%
Unitedhealth Group	15%
Wal-Mart	9%

*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 5.4% last year. Just as in other years, the average reflects some industry-specific issues. But with due allowance for issues of this kind, 2011's results were adequate, challenged by comparison with strong 2010 earnings, but supported by generous governmental spending initiatives that continue to offset contraction in private sector credit.

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. For the last few years, however, financial stress has caused earnings to move more widely than the market. As a result, we wish to share with you how we think about volatility in earnings. Since this is a repeat of prior discussions, 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 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.

For that reason, we also attempt to discern the sources of earnings and their likely continuation. The result is the purchase of two types of companies: those with volatile earnings in which we follow the preceding dictum of "buying assets" and others whose global exposure seems more likely to sustain long term growth. The former have more volatility and tend to be held for shorter periods of time, while the latter form an almost bond-like presence in our portfolios and are held for very long periods. This combination has been critical to our investment results.

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, and if, the tide of mispricing in "risk-free" assets 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 Clark 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