October 11, 2011

Enclosed is your statement for the third quarter of 2011.

For the quarter, equity investors saw total returns of -13.87% for the S&P 500, -11.49% for the Dow Jones Industrial Average and -12.7% for the technology-oriented NASDAQ. For the quarter, fixed income investors saw total returns of 0.18% for the 1-year Treasury Index, 4.48% for the 5-year Treasury Index, and 12.18% for the 10-year Treasury Index. The 10-year BB- corporate bonds had total returns of -2.63%. In a quarter reminiscent of the 2nd quarter of 2010, investors ran for the shelter of "quality," rushing primarily into U.S. Treasury bonds, despite record low yields and a Standard & Poor's rating downgrade. Secondarily, investors purchased the stocks of companies with strong balance sheets and dominant franchises, causing generally stable prices in our holdings.

Conditions change - sometimes rapidly. With the ink barely dry on last quarter's letter defending high cash holdings, investors' anxiety flared concerning Greek debt and potential contagion. Within some sectors, most notably housing, technology and financial, prices have dropped, becoming remarkably close to those of the Great Recession of 2008. Panic has driven investors into high-priced gold and even higher priced U.S. Treasuries as pundits have pointed out the economic dominoes that are certain to knock each other down into worldwide collapse.

In many ways, the issues facing the world are not all that new. Take the issue of Greek default. A recent economic history has documented that Greece was in default for over 50% of the 20th century. Or the issue of European contagion. For centuries, European countries have brought "contagion" to an art form as each country sought to manipulate its neighbor into a mutually profitable alliance, frequently only to end in tears. The exchange of their individual money printing presses for a shiny new common Euro printing press is only the latest model. Or how about the issue of domestic squabbling over who pays the appropriate tax burden? That is perennial. Or the issue of Asian ascendancy. Twenty years ago, U.S. students were learning Japanese, but now they are being schooled in Mandarin Chinese. That's why the four most dangerous words in investing are: "this time it's different."

We have no idea what the fate of Greece or the Euro is, who will succeed candidates for political office or how the ascendancy of various nations might play out. Fortunately, our discipline is based on pricing, not forecasting. The presence of the Atlantic and the Pacific, a sound legal framework and a powerful military allow us to focus our energies on identifying durable business franchises and pricing their "intrinsic value." For all of its foibles, frauds and challenges, the U.S. continues to grow the most desirable crop of businesses in the world and we are picking the fruits of this tree when the prices are low enough for our reach.

The current panic is helpful in these efforts, although it can be a source of unease for our clients. In addition to reciting the maxim, "things are never as good or as bad as they seem," it may be comforting to remember that we are not purchasing pieces of paper or blips on a computer screen. Instead, these are fractional interests of powerful economic enterprises, typically global, which have withstood wars, plagues and depressions. The price movement of a day or a month is not that relevant when our ownership period targets a decade or longer. In addition, we have the rare situation in which the average dividend yield on our companies is higher than those on cash, C.D.s, or 10 year US Government bonds.

As always, our shopping has been systematic. We give priority to increasing ownership of shares we already own if prices on those shares drop significantly. Further, we even distinguish within our portfolio of companies, preferring to buy shares of companies whose business franchises seem relatively stronger. Out next priority is to expand ownership into new companies. Some of the stocks recently purchased, we have researched for over fifteen years, regularly discussed them every three to six months and are now finally getting to own. That's why it's frequently heard around our firm that "every day is Christmas!"

We hope this letter helps you increase your understanding of our approach. 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