January 16, 2013

Enclosed is your statement for the fourth quarter of 2012.

During the quarter, prices of many assets rose, as central bankers around the world suppressed interest rates and pledged loyalty to investors in order to support a sense of well-being.

These strategies have worked so far. But the environment continues to be problematic for owners of cash equivalents and bonds because, in the poetic words of interest rate observing James Grant, “the income has been removed from fixed income and the yield from high yield.”

By tradition, our fourth quarter letter discusses the investments which have generated the best and worst results for the prior year. While this exercise has been pleasurable and interesting, we have come to believe that it has a fundamental flaw – the time horizon is much too short. In fact, with some regularity we ended up simply discussing our most volatile positions, not really the investments which have had the most impact. Instead, we want to focus our fourth quarter letter this time on stocks we have sold this past year. We hope this will be a better means of understanding where our results come from in the long run and the investing principles and processes we employ. Unfortunately, we have initiated this change in a year of multiple sales, so our letter will be longer than usual. We discuss these sales in alphabetical order after a short, but perhaps helpful, digression.

Benjamin Graham, the father of stock analysis, said the market is a voting machine in the short run, implying that it is subject to wide variances from reality, but, in the long run, the market is a weighing machine. So, inquiring minds would like to know, “when do we get to the long run?” What results are long enough? At Academy, we tend to view the market as a voting machine when we discover stocks valued significantly below our own valuation. But because the companies in our portfolios are chosen for long durability, we view the market as a weighing machine once we own the company. For example, we have argued that the miniscule return of the S&P500 over the period described above is not the result of poor business performance (thus, reflecting underlying conditions), but instead reflects excessively high, 'voting machine', pricing in the early years of 1999 and 2000. The longer the period of time, the less the starting price will affect returns. However, a 100 year time horizon is not something most of us are interested in. As John Maynard Keynes said, “in the long run, we are all dead.” So maybe we can say, as a working definition, that when the results generated are driven more powerfully by the business performance of the particular company than by price volatility in the broader market, we have arrived at the long run. This fourth quarter letter will be a necessarily imprecise attempt to capture this dynamic.

Allstate Corporation was a major holding in our portfolio for more than a decade. We purchased our first position up to 1.5% in October 1999. At that time, the combination of a technology bubble and horrible insurance underwriting conditions resulted in a stock price well under book value. In the insurance business, book value is an important number because capital determines capacity. As the technology bubble peaked in early 2000 (in fact, on the day of NASDAQ’s all time high), we more than doubled our position up to 3% after the price dropped more than 20% from our initial purchase. This

illustrates an important principle we have often discussed in these letters: declining stock prices are the long term investors' friend. We continued to purchase shares for new portfolios at levels up to 3% until the dark days of 2008, when we purchased up to 4%. Then, as the financial markets healed, we sold down to 1.5% in 2010 and finally sold all of our position in 2012.

We did not wish to liquidate our position in Allstate and continue to be impressed by their market position, execution and brand, but were concerned about an unpriced risk we saw. Life insurance companies are especially dependent on investment income. Although Allstate is a dominant property and casualty insurance company, the life insurance division is sizable. We wondered, "What happens to life insurance companies without investment income?" This led us to study Japanese life insurance companies. From this, we learned that if interest rates stay down (which we don't pretend to forecast), then the life insurance division of Allstate could develop real problems. As we became less comfortable with this risk, we reduced and then eliminated our position. The average annualized equity performance for Allstate from October 1999 forward was 11.8% (with a wide range of individual outcomes based on dates of entry). This compares very favorably to the annualized performance for the same period for the S&P 500.

American Express was another company which we owned for nearly a decade, but not continuously. We purchased our first position up to 1.5% in September 2001 which we quickly sold in April of 2002 because the stock moved up over 50% in a brief period, in a case of stock price seeming to outrun business value. Then in July 2005, we purchased American Express again, but this time up to 3%. We purchased a larger position than in 2001 because we rated the durability and quality of the business franchise higher. Subsequently, as the stock dropped, we raised our percentage ownership to 4.5% in 2007. Then in 2008, we purchased heavily, ultimately building our position up to 6%. As the markets healed, we systematically trimmed with our final position sold in 2012.

Like Allstate, we did not wish to liquidate our position in American Express, but the troubled times of 2009 intensified awareness of the company's credit risk. In 2008, we began to model how unemployment intersected with American Express and concluded that its credit card operation (as distinguished from its charge card operation) could bankrupt the company if unemployment reached 12%. We try to purchase stock only in "kill proof" companies. While we did not believe that death would occur during this crisis, we do believe it could in the next crisis, especially if the U.S. Government is less generous with financial companies than it was during the last one. This analysis was the driving force for us to reduce and then eliminate our position as the stock price rose. The average annualized equity performance was 6.3% (again with a wide range of outcomes based on entry date). This compares favorably to the annualized performance of the S&P500 during the same holding periods.

In the interests of a balanced discussion, this result was good, but not nearly as good as it might have been. Rather than continue to treat American Express as we did in 2001 with a 1.5% initial position, in 2005 we started with a bigger 3% position. When the 2008 crisis continued to drop stock prices into 2009, we were unable to continue purchasing at some eye-popping bargain prices because, as they say in Las Vegas parlance, we were already "all in." This does point to one of the important reasons for that cash which some may think is burning a hole in your portfolio. Your cash represents an opportunity to capitalize on the variability and enhance investment results.

The next position was really a collection of positions we call Big Oil, made up of ConocoPhillips, Phillips 66 and Total, S.A. We did not hold these positions for long. We purchased our first position of 1.5% in ConocoPhillips and 1.5% in Total in the fall of 2011. At that time, investors were concerned that Euro currency issues would hurt economic growth.
Resource prices took a sharp nosedive and, always on the lookout for bargains, we bit. ConocoPhillips and Total struck us as particularly undervalued relative to a group that had become undervalued. Having made those two investments in Big Oil, we continued to attempt to deepen our understanding. As we studied the huge amount of information available, we came to one clear conclusion: Big Oil, as a commodity driven licensee of national assets, was impossible for us to price adequately. You could say we did not have confidence in our own ability to 'weigh' it, let alone the market's, so we could not commit to the long run. During 2012, we sold our positions in Big Oil.

In light of our growing awareness of our limited understanding, we were extremely careful in the size of our purchases and the price we were willing to pay. The results were favorable. In the combined ConocoPhillips/Phillips 66 position, our less than one year hold returned 26%, while our one year hold in Total returned nearly 13%. In addition to favorable investment results, our ownership in Big Oil did help us identify companies in the resource area which we believe are subject to better understanding and more closely fit the characteristics of the companies we look for.

The next position was in Omnicom. Omnicom is a powerhouse collection of advertising agencies including BBDO and DDB Needham. We have followed Omnicom for years and greatly admire the company's ability to centralize execution but maintain a decentralization of the creative functions so critical in this industry. Because of its global reach and exposure to Europe, the stock finally dropped within our purchase range during the fall of 2011 because of the same anxiety over the Euro. Again, new to purchases within the industry, we limited our initial purchase to 1.5%, looking for a lower price or greater understanding before increasing our holding. After one year, we sold our position for a 45% gain.

As with all of our investments, we wished to hold Omnicom for a long period of time. However, as we studied Omnicom in more depth, we became concerned about the reduced profitability with the fragmentation and rapid disruption of media. TV shows that would not have made the Top Ten in viewership in the 1980s would now be far and away in first place. The concept of getting lots of coverage efficiently also suffered with the rapid implosion of traditional newspaper business models. The result is that the legacy businesses are dying, though still highly profitable. Clearly Omnicom will be a major force in the evolving environment, but this is a situation we would rather observe and revisit when these factors are more defined.

The final position, alphabetically, was in UnitedHealth Group. In the fall of 2006 we initiated a position up to 1.5%. Business results were favorable and our understanding deepened so that we were comfortable increasing our position to 3% in the summer of 2007. In early 2008, the company became embroiled in accounting controversy with a stock option issue of its longtime CEO. We continued to increase our position as the stock dropped to 4.5% then 6% then 7.5%. Later in the fall of 2008, as the world was imploding, the stock price rose by nearly 50% and we trimmed the position. Then the

world collapsed and we purchased more shares. Then gradually we reduced and then eliminated our position. What was the result of six years of owning and understanding a dominant business (70 million Americans!) that had increasing profitability combined with excellent trading at Academy? Just under 1% per year.

This investment result was frustrating. Every time an issue seemed resolved, another one seemed to lurk around the corner. We continue to be impressed by the business economics. Health insurance is no longer insurance in the true sense of risk-bearing capital. Instead, it is a service function that was simply an efficient way to deliver healthcare on initial purchase. We like businesses that do not require capital at risk. Later, when health insurance companies started to bear the brunt of consumer wrath for rapidly increasing premiums, we believed that such storms would pass. But we decided to abandon this profitable area once we concluded that recent health care reforms may be designed to: rationalize and fund universal healthcare by setting up a fight to the death between insurance companies. The ultimate result may be a nationalized system. These are not businesses we can 'weigh', either. We do not foresee reopening their files.

We hope this rather lengthy letter deepens your understanding of our process. We want you to stay informed and feel comfortable about our investing discipline. In communicating, we try to “do unto others as we would want done unto us.” If you’re new to Academy, past quarterly letters may be useful and may be obtained through your financial advisor or Joyce Bell at our office. In addition, our website (at www.academycapitalmgmt.com) has our investment reports on the individual holdings in your portfolio.

In accordance with regulations, we have enclosed a copy of Academy's Privacy Notice, and we will gladly make available a copy of our updated Form ADV - Part II (our regulatory filing with the SEC). If you would like one, please contact Robert Stovall at our office.

As always, we appreciate the stewardship responsibilities you entrust to us and your patience with our investment process.

Academy Capital Management